

**Portugal's European integration:
the limits of external pressure¹**

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1. Introduction

1.1. Europe before Y2K

European integration has combined deepening economic interdependence and mutual political responsiveness among EU members and widening membership. The combination began when a Community of six that had completed the customs union ahead of schedule accepted the central member of the European Free Trade Association (EFTA, whose original members were known as “the outer seven”). Some twenty years later, the same combination was observed when three other EFTA countries became members of what had become a twelve-strong union (EU) on its way to creating a single currency. In the meantime, the fall of the Berlin wall greatly increased potential membership. Fears surfaced that, if deepening and widening were simultaneously pursued, negative spillovers would more than offset the benefits from positive spillovers. Sequential approaches were therefore adopted. Yet, if faster widening proves unacceptable to members and faster deepening hurts the expectations of candidates, chances are that both will continue to stall.

In that sobering context, it is helpful to remember that European integration is made of individual country responses to both external and internal pressures. Success stories that are generally unknown may provide lessons to the dozen accession countries likely to be involved in future enlargements. It may thus be said that both member states and candidates for accession face policy challenges due to the combination of deepening and widening that actually prevails.

Looking back, the nature of membership has been shifting. The degrees of commitment to the union and to each one of its main institutions have been changing in various issue-areas, as a partial response to a more turbulent global and regional environment. The euro was created in January 1999 among most of the fifteen member states but the resignation of the European Commission (EC) shortly thereafter delayed the accession calendar. The strains introduced in the balance of power between institutions were exacerbated after the parliamentary elections in Spring changed the majority from the European socialist to the popular party. Another challenge had come from military actions in Kosovo, which brought the need for reconstruction and stability in the Balkans. Albeit conjunctural, these two developments may have changed the perception of Europe to a greater extent than the euro, whose introduction had been planned for over ten years. Hopefully the new EC will be able to combine internal reform and external visibility. Deepening and widening continue to be the most salient issues for the EU: the report of the “three wise men” requested by EC president Romano Prodi shortly before he took office begins by saying that reform is urgent and the enlargement is imperative².

¹ Earlier versions were presented at the Harvard Center for European Studies, the Bertelsmann Foundation and an international management seminar for the Autosil Group in Sintra. Comments from participants are gratefully acknowledged. The research originally conducted for the World Bank project *Towards European Integration* is described in a companion paper with the subtitle *Lessons for future enlargements*.

² See Weizsacker et al (1999) and note 8 below.

Given a policy environment fraught with ambiguities, both deepening and widening are likely to be slow and differentiated processes, making recent accessions of relatively poorer countries useful cases for comparison. While Greece and Ireland are seen as polar cases in what pertains to the capacity to absorb structural funds, Portugal shares features with either one. The lessons may thus appear of greater relevance³. In any event, the interplay between political, economic and social factors will continue to make the EU a shifting constraint for members and a shifting objective for candidates.

Aside from the constraints imposed by membership, there are constraints imposed by past policies, and they are also shifting. Structural adjustments take place at different speeds, changing the attractiveness to investors and the degree of social cohesion in ways that lessen or exacerbate the ability to reach the moving target. Past and present candidates for accession may have common features, but to a great extent the relevant constraints reflect the specific country experience. This provides another reason to select one national case and understand it fully, rather than pick and chose between various allegedly polar cases of success or failure. Indeed, in all accession processes, there will be success and failure.

To assess the costs and benefits from membership, the situation before joining should be combined with the evolution of the EU itself. The limits of external pressure are illustrated by the fact that the competitive forces unleashed by the euro do not suffice to bring about public sector reform. This may be called a “euro hold up” and can be observed among most of the eleven members, with the possible exception of the Netherlands, which has successfully managed to carry out structural reforms through consensus, along the lines of the “polder model”. Portugal has yet to develop such response.

1.2. Outline

This attempt to disentangle the shifts in objectives and constraints stemming from the Portuguese experience with successively tighter forms of European integration is organized into five sections plus this introduction and a conclusion. In connection with the trade-off between integration and transition, Section 2 establishes the shifting balance between economic and political integration and shows its historical roots. Constitutional constraints on Portuguese integration, political and fiscal, are taken up in Sections 3 and 4 respectively. The delay in implementing a credible multiannual fiscal adjustment strategy (MAFAS) when banks served as implicit tax collectors is further explained in the annexes⁴.

Paradoxically, the constraints are constitutional because Portugal was subject to four successful political revolutions this century, all of which had some social concerns behind them. Revolutionary rhetoric aside, the “fiscal constitution” remained the same. In other words, the ability to redistribute power and real resources to the population at large did not increase, suggesting that some social groups were able to distribute external resources among themselves in a more or less coordinated fashion. For some purposes groups can be identified with parts of the government, in particular spending ministries (e.g. public works, education, health), possibly in alliance with industry or union lobbies (construction, teachers, pharmaceuticals). In other cases, the groups can be identified with traditional institutions, like the church, the armed forces, the judiciary, etc. Aaron Tornell and Philip Lane (1996, 1999) model this group influence on the tax/transfer mechanism. They show that it implies some form of “common access” to the aggregate capital stock, and that each powerful group

³ The advantages of differentiated integration are pointed out in Bertelsmann (1999). The analysis is in CEPR (1995). As described in my (1995), the Portuguese parliament favored “positive variable geometry” as a broad principle for the revision of the EU treaty. See also Magone (1997).

⁴ The analysis in annex 1 draws on my contribution to a volume edited with Christopher Bliss (1990), titled *External Liberalization under Ambiguous Public Response: The Experience of Portugal*, while annex 2 updates my (1999), with Luís Catela Nunes and Francisco Covas.

ignores the effect of the transfer it extracts on the taxes levied to balance the government budget. As a consequence of each group's voracity, aggregate transfers rise more than proportionately. The "voracity effect" is consistent with openness to trade and investment, up to the point where increased economic interdependence eliminates the ability to protect vested interests from external competition.

Similarly, better coordination among powerful groups, perhaps due to a unitary rather than a divided government, are shown by Tornell and Lane (1998) to decrease the voracity effect and to limit "fiscal euphoria". They show that such fiscal euphoria has dissipated terms of trade improvements in many countries, especially those with weaker institutions. A specific feature of the last revolution, which is consistent with a tax/transfer mechanism resilient to the political upheaval, is that macroeconomic adjustment focused on real wages to a greater degree than is usual in Western democracies. Since public sector workers remain protected, section 5 suggests that the labor market is not as flexible as real wage adjustment alone would suggest.

A Pre-Pegging Exchange Rate Regime (PPERR) - that entails essentially no active nominal devaluation aimed at real devaluation - was adopted before the entry of the *escudo* into the euro. The PPERR followed several attempts, described in annex 2, at resisting the regime change on the part of interests vested in the fiscal constitution. The gyrations in relative unit labor costs during the 1989-93 period reflected domestic policies rather than external shocks. Ambiguous responses were thus observed up to joining the Exchange Rate Mechanism of the European Monetary System (ERM) in 1992. They made it more difficult for domestic citizens than for international investors to be convinced of the change in economic regime towards currency convertibility and stability. Had domestic policies been less ambiguous, structural reforms might have been implemented with greater vigor, and better governance achieved in private enterprise and in public administration, at the expense of vested interests.

In public debates and in the media, ambiguity was less pronounced from 1991 to 1995. The socialist government started with a more eurosceptic outlook, which was actually shared by the opposition parties, and spoke with irony of the social democratic government having been a "good student" of the EC, then led by Jacques Delors. In the run-up to the October 1999 general elections, the protectionist bias on the part of the administration and of the major economic and financial groups resurfaced. This revival of nationalist responses seemed welcome by the electorate and there was a slight increase in the number of socialist seats, which nevertheless remained one short of a majority.

Section 6 shows that the type of international specialization followed since the application for membership was lodged also reflects defensive domestic policies, aimed at preserving the fiscal constitution in the face of external pressure. The pattern of trade and investment also reflects the ambiguous response to external liberalization.

An assessment of the costs and benefits from membership is presented in the conclusion. To be sure, joining the euro multiplied the effects on firms and consumers of the single market in financial services established in 1993. Nevertheless, the positive response of Portuguese firms to globalization, based on the current virtuous cycle, cannot be divorced from a greater social anxiety than during the vicious cycles before accession. And the consequences of the "euro hold up" are of course more serious in a country where, over more than three decades public sector reform has been called for, but shows no sign of being implemented in ways that may threaten the interests vested in the political and fiscal constitution.

2. Integration and transition

2. 1. Factors of regional integration

To better understand the beneficial effect of external pressure, recall that several crucial propositions from international trade theory must be modified when allowance is made for the existence of public goods. Alberto Alesina and Romain Wacziarg (1998) assess the costs and benefits of European integration in a model with public goods⁵. Richard Cooper (1974) pioneered the approach, showing that the optimum size of the integrated area differs for private and public goods. Whereas technological forces lead to a global area for private goods, different preferences for the provision of public goods, in particular across cultural boundaries, point to a much smaller optimal area there. Taking into account that the ability to appropriate and redistribute resources is itself endogenous, the reduction in scale may vary with the homogeneity and the distribution of power in society.

The general lesson comes from Charles Kindleberger (1962) who argued that a country showing capacity to transform benefits more from international trade than a rigid economy. But it is not always understood that the result of a favorable external shock can be equivalent to that of natural rigidity. When the surplus is appropriated by the state, perhaps itself an instrument of powerful but uncoordinated social groups, it may damage growth prospects and leave society worse off than it was before the favorable shock. This enhanced rigidity of economies experiencing a terms of trade or a productivity boom which is redistributed to competing social groups, including state agencies and enterprises, has been observed in several developing countries and called the voracity effect⁶. The state and other vested interests only redistribute taxable capital. Then civil sector workers share in this redistribution and are in conflict with both private sector workers and “informal capital”.

Aside from economic interdependence, then, socio-cultural homogeneity and mutual political responsiveness (in the sense of coordination among social groups) are also required for regional integration. Bruce Russett (1967) used factors such as “economic development”, “Communism”, “intensive agriculture”, and “Catholic culture”. He argues that, in the late 1950’s countries fit into four geographically well-defined regions, Afro-Asia, Western Community, Latin America, and Eastern Europe plus a group half-way between the Western Community and Latin America which included Spain, Portugal, Chile, Uruguay, Puerto Rico and Cuba.

The factors chosen give a measure of the perceived distance between the Western Community and this founding member of the North Atlantic Treaty Organization (NATO), of the Organization for European Economic Cooperation and of the European Payments Union. The more readily available indicator of distance is economic development, as measured by GDP per capita at current prices and purchasing power standards, which was then less than half the EU average in the 1940s, when the longest transition to European integration began. Fifty years later, the case of Portugal is rightly seen as a success of European integration. Nevertheless, there were several missed opportunities, largely due to a defensive accession strategy and inappropriate domestic policies. The persistence of these policies reflects

⁵ On the design of institutional reform mentioned in note 2 above, they conclude, “the EU has gone too far on most issues” but then stress that “the process of coherent institution building has lagged far behind”.

⁶ See Tornell and Lane (1996, 1998, 1999) and Tornell (1999). The model shows that if the number of groups capable of influencing the tax/transfer mechanism increases voracity decreases. In Portugal, the number probably rose with European integration, but not enough to eliminate the alliance between private sector labor and informal capital implied by the model. On top of that, banking, monetary and exchange rate policies appeared to favor civil servants and taxable capital, thereby discriminating against this alliance.

resistance on the part of potential losers from integration. The defensive accession strategy is rather rooted on a lack of confidence about the ability of Portugal to “make the grade”. Such skepticism prevailed in business circles and civil society even during the phase when the authorities attempted to be “good students” of European integration. According to polls taken before the parliamentary elections of spring 1999, the Portuguese continue to be among the nations who trust European institutions the most. The idea that success of integration could have been greater is therefore difficult to convey to public opinion. The groups whose ability to capture government transfers has diminished due to the single market perceive themselves to be losers but do not necessarily claim that integration was a failure. This hesitation is especially visible in the political parties on the right. The opposition of the communists and other parties on the left continues to be cast on ideological grounds, with reference to the period when the transition to socialism was explicitly charted in the Constitution – which lasted until privatization of nationalized enterprises was allowed in 1989.

This is why dating the beginning of Portugal's European transition helps define the strategy pursued. Taking an exclusively institutional approach might suggest 1977, when the request for membership was made, or 1972, the date of the free trade agreement with the Community. Instead, the development strategy approach taken here suggests that the decisive step was belonging to EFTA since its inception in 1960.

Spending a quarter century in EFTA allowed Portugal to develop an export base in manufacturing, which proved decisive after the 1974 revolution - when policies were reversed. Paradoxically, by averting more serious balance of payments crises during the negotiations for EU membership from 1977 to 1985, the export base reinforced some of the interests vested in state intervention. One reason for the paradox is that Portugal's transition to European integration did not balance mutual political responsiveness with economic interdependence. In addition, the “*acquis communautaire*” is not equivalent to free trade, and in some sectors like agriculture, it actually goes the other way. The Portuguese experience suggests a trade-off between transition and integration.

Recurrent agreements with the International Monetary Fund (IMF) imparted a “stop and go” pattern to economic growth but spared the enlarged public sector, including state-owned enterprises. This magnified the negative effect on labor and capital employed in the private export-oriented firms, which behaved almost like an “informal” sector.

The imbalance between economic and political integration has social implications to the extent that it threatens the government's capacity to balance economic transformation and social cohesion so as to preserve political legitimacy. This capacity is even more needed when there is an implicit or explicit ranking of the progress of accession. As Portuguese negotiations for membership went along in parallel with those of Spain, EU membership had the (almost unintended!) effect of bringing about free trade with Spain. Because of the geographical proximity, Spanish imports and investment were resisted, especially in agriculture and banking. To pursue a defensive strategy with respect to one partner and remain cooperative with respect to others is easier if responses to external liberalization are ambiguous. Coupled with gradualism, this ambiguity makes policy reversals likely. It also leads to exaggerating the importance of so-called “geographic fundamentals”.

The Portuguese pre- and post-accession experience combined gradual adjustment and ambiguous responses to external pressure. This was based on the fear of economic integration with Spain, but the pattern is also consistent with domestic policies aiming at preserving state intervention even if it reduces social welfare. Constitutional constraints, both political and fiscal, capture best the defensive domestic policies followed when Portugal was set on a

transition from market to plan, inverse from that of the central and eastern European countries (CEECs)⁷.

2.2. The record of European convergence

The government of Antonio Salazar accepted Marshall aid and so took up the challenge of catching up with the rest of Europe. Yet at the same time the government was determined to hold on to the African possessions, which were turned from colonies into provinces in the 1951 revision of the Constitution.

In the early post-war period control over public spending and the accumulation of foreign exchange were the keys to defending the currency and securing the financial independence of the state. This implied strong supervision by the central bank over the mostly family-owned financial conglomerates which began to erode when labor migration brought with it widespread access to foreign exchange.

Barriers to foreign competition were part of a regulatory environment that also featured investment licensing in many industrial sectors. Economic exchanges with the colonies were also regulated despite the fortress idea, expressed as an objective of 'national economic integration'. Yet competition prevailed, fortunately, in sectors where in the late 1950s trade was liberalized in the framework of the EFTA. In 1961, Portugal joined the General Agreement on Tariffs and Trade, the World Bank and the IMF.

Thanks to sizeable migrants' remittances, tourism and growing foreign investment; gold reserves piled up during the 1960s. Against the background of the first enlargement of the Community to include former EFTA partners Denmark, Ireland and the United Kingdom, Portugal signed a free trade agreement with the Community in 1972. This crowned a successful decade of export-led growth, which was followed by a stock market boom. Export growth was so pronounced in clothing that Portugal was sometimes labeled as a 'pajama republic'⁸. Existing exchange controls were unable to prevent growing financial interdependence.

The response to external liberalization remained ambiguous, though, as the idea of 'fortress Portugal' was also accentuated in the 1960s, due to the colonial wars. Ambiguity interacted perversely with an economic structure where agriculture remained traditional, industry was tightly regulated and banking was subordinate to a few industrial conglomerates. In spite of an attempted liberalization by Salazar's successor, Marcello Caetano, this did not change until the first oil shock, which hit Portugal with particular severity.

Moreover, the political situation disintegrated to the point where the fifty-year-old authoritarian regime fell without resistance on 25 April 1974. A military junta took power and vowed to 'democratize, decolonize and develop' in the name of the people. Democracy and development soon became equated with an 'original' brand of socialism, but the originality was constrained by the combined influence of the armed forces and of the Communists. The Common Market was seen as a capitalist and imperialist threat. Economic solidarity with the eastern bloc and the Third World was proposed as a superior development strategy.

In other words, the revolution maintained the fortress mentality but the domestic objective constraining European integration changed: colonialism was replaced by socialism. Both were understood to be strictly domestic objectives rather than manifestations of international trends. On 11 March 1975, under the threat of a military take-over, firms in sectors protected from competition, especially the financial conglomerates, were nationalized without compensation

⁷ They include ten candidates to EU accession. The lessons of Portugal for future enlargements are stressed in the companion paper cited in note 2 above.

⁸ Yet the chemical industry, plastics in particular, may have been more important than textiles in establishing the roots of intra-industry trade specialization, which nowadays features exports of auto parts and other technology intensive goods, as discussed in section 6.

to shareholders. To ensure the transition to socialism, an article of the political constitution passed in 1976 froze the post-revolutionary widespread nationalization as 'irreversible conquests of the working classes' until the second amendment, voted in 1989 overturned this irreversibility. Nationalization without compensation had the effect of greatly enlarging the public sector virtually overnight with no side effects on revenue, while the irreversibility of the nationalization basically froze the enlarged public sector. This seriously hindered the process of economic restructuring called for by the global shocks of the 1970s – at a time when the distance to Western community norms had shrunk as the GDP ratio peaked at almost two thirds of the EU average.

The European Investment Bank approved an emergency loan to Portugal in late 1975, which was incorporated in the June 1976 additional protocol to the 1972 agreement. This implied in particular that the calendar for dismantling of Portuguese tariffs on industrial products was postponed from 1980 to 1985 while the complete elimination of Community tariffs was anticipated from 1977 to 1976 and new tariffs on infant industries could be levied until 1981. The agreement was, however, not applicable to “sensitive” industrial products and to transformed agricultural products.

In March 1977 the socialist government led by Mário Soares, who had been in exile during the Salazar regime and became the symbol of the Portuguese democratic renaissance, formally applied for full membership in the Community and the EC advised the Council to accept in April 1978. Negotiations opened formally in October 1978 but problems of bureaucratic politics on both sides delayed accession until January 1986.

According to polls conducted during the negotiations, over half of the population of the two largest cities did not know what the common market was. Yet European integration was taken as given by the urban population who considered it a step in solving the “economic crisis”. This may be related to the disappointment of the euphoria of the revolution, which would be easy to infer from the brutal drop in real wages.

The Portuguese economy was already beginning to catch up again in 1977, when the application for Community membership was lodged and agreement was reached on the first IMF stabilization program featuring a devaluation of the *escudo*. It is worth noting that the combined expectation of trade liberalization and of microeconomic stabilization did not appear to hamper the process of catching up. Flexibility in the “informal” economy was such that exporting firms and workers adjusted sufficiently to compensate for the downward rigidity of public expenditure.

The relentless expansion of public debt that resulted from the enlarged public sector made private firms the residual borrowers from credit enterprises. The private sector was subject to recurrent squeezes because of “stop and go” macroeconomic policies. These were in part politically motivated cycles, which occurred even when two governments with the same coalition of parties succeeded each other. Thus Portugal’s business cycles were often more pronounced than those of its main trading partners. The first non-socialist coalition government led by Sá Carneiro, a dissident from the Caetano regime, stabilized inflation in 1980, and the second government of the same coalition led by Pinto Balsemão (who succeeded Carneiro after his mysterious death in a plane crash) expanded during the world recession of 1981-82. A coalition government of socialists and social democrats led by Soares had to call the IMF and stabilize during the world boom in 1983-85. Government lasted on average less than one year.

Relative GDP per capita fell in 1983. Thus the second IMF stabilization program, unlike the first, reversed the catching-up process. This time the consequences of the frozen public sector and voracious vested interests were too strong to be offset by a fall in real wages. The effect

was exacerbated because the Portuguese economy was out of phase with the Community economies.

In late 1985, a social democratic government led by Cavaco Silva, a central bank economist who had been the minister of finance in the 1980 endeavor, identified meeting the 1992 deadline as the major challenge facing the nation. The objective of economic and social cohesion was seen as requiring Portugal to meet this challenge.

European challenges aside, there are political and social roots for revenue-seeking behavior, which go back to an ancient feature of the Portuguese fiscal constitution. Since the late 1300s, in effect, new taxes were created on the occasion of wars against Spain but the crown was unable to collect them in peacetime. As a consequence, various royal monopolies and the inflow of Brazilian gold served to finance public expenditure during the 1700s. When non-tax revenues dried up with free trade and the independence of Brazil in the 1820s, a process of divergence with the EU average began⁹. As shown in Chart 1, based on data from Abel Mateus (1998), divergence lasted until the Second World War.

Chart 1 Long term convergence with the EU 1820-2000

The GDP ratio did not manage to reach the initial level until the early 1970s, when macroeconomic management under flexible real wages and exchange rates induced another process of divergence, discussed in section 5. Voracious vested interests freeze the public sector. In the 1700s, these interests reflected the inability to raise taxes in peacetime. Since accession in 1986, then, Portuguese gross domestic product (GDP) per capita has been catching up with the EU average at the rate of over two percentage points per year. Yet both structural adjustment and faster growth have been hindered by the unwillingness of successive governments to reform the public sector. Electoral promises notwithstanding, governments did not lower public expenditures as a percentage of GDP and did not eschew the inflation tax until required to do so by the external pressure to fulfill the convergence criteria for the euro. Nowadays, the *escudo* is part of the euro and the ratio to the EU average is expected to reach three quarters in 2000, allowing for the effect of German unification. This external pressure has not changed the fiscal constitution. As discussed in section 4 below, it appears as the last holdout from the constitutional ban on privatization.

2.3. Gradualism vs. balance

By the late 1980s, Portugal reached a level of gross domestic product (GDP) per capita slightly higher than Greece. This was heralded as showing that the country was no longer 'at the tail of Europe' and that Portugal would 'win 1992'. In the 1992 EU Treaty, Portugal and three other countries (Greece, Ireland, Spain) became eligible to tap the "cohesion fund" for national rather than regional interventions. Balance between economic and political integration obtained during the Council presidency in the first half of 1992, perhaps the heyday of the "good student" phase. Diagram 1 illustrates the pattern of Portugal's transition by plotting economic and political integration into Europe along the horizontal and vertical axes respectively. If this is done in such a way that the 45° line represents a balanced path, Diagram 1 shows how rising economic interdependence in the 1960s was followed by greater mutual political responsiveness in the 1970s. The newly founded democratic parties (socialist, social democratic and social centrist), supported by external actors, such as the World Bank, the IMF and foreign non-governmental organizations (like the foundations linked to major German political parties), stimulated the process leading to European integration. Only the communist party opposed it, as membership threatened the transition of Portugal to a soviet-style regime.

⁹ This is discussed in my (1998) with Alvaro Ferreira da Silva and Rita Martins de Sousa.

Diagram 1 Pattern of economic and political integration

But Diagram 1 shows two reversals. The leftward movement corresponds to a reduction in economic interdependence, due to exchange controls imposed in 1990-91. The downward movement reflects a drop in mutual political responsiveness following the veto of a cross-border bank merger in June 1999, lifted after the October elections. As it turns out, this was just ahead of a new EU Council presidency. The negative consequences in financial reputation are likely to last beyond the first half of 2000, however.

Moreover, in spite of government pronouncements and advertising efforts, the internationalization of the business community did not start until the late 1990s. Even now fears of failure still prompt lobbying efforts aimed at delaying integration or at limiting its scope but doubts as to whether the catching-up already secured can be maintained echo a fear of “geographic fundamentals” which would make Portugal follow Spain in bad times but not in good times. The doubts rarely reflect awareness that public sector reform has been inadequate. For example the economic sentiment indicator produced by the EC shows that the range between the peak in 1987-91 and the trough in 1991-95 is over seven percentage points in Portugal, more than twice as large as in Spain, even though the unemployment rate there was almost four times bigger.

The fear of “geographic fundamentals” is consistent with prevailing expectation of an unfavorable future performance with unemployment, against the evidence of the last ten years. As a consequence of the severe real wage decline achieved in 1983/85 in agreement with the IMF, Portugal has recorded a rate of unemployment about one third that of the rate in neighboring Spain. Certainly the perceived link of the *escudo* with the peseta does not explain why international financial markets believed in the regime change almost five years before trade unions, employers associations and citizens. No matter how erroneous, “geographical fundamentals” cloud national perceptions of the benefits of economic and political integration with Europe, insofar as the bilateral consequences are valued disproportionately.

3. The Constitution and political stability

3.1. Taxes and vested interests: the discipline of external credibility

A feature of the constitutional system in Portugal has been the difficulty in creating stable parliamentary majorities. Two large parties (socialist and social democrat, in PSE and PPE respectively) have been competing for the median voter but alliances with smaller parties on the right and the left have kept the structure of the party system fairly low. Moreover, the division of powers between prime minister and president of the republic prevailed even within the strong single-party executive governments of 1985-95 as economic policy oscillated between earning credibility abroad and selling stability at home, typically in the run-up to the 1991 and 1995 elections. The reelection of a socialist president in 1991 reintroduced the dilemma of the bipolar executive with a vengeance and the social democrat government did not resist the effects of the international recession and the slowdown of reforms it implied. The socialists led by Antonio Guterres won the October 1995 general elections – again on a reformist platform. Cavaco Silva (the only prime minister who managed stable parliamentary majorities), had refused to run in February and was beat in the presidential elections of January 1996 by the socialist candidate. The 1999 electoral campaign suggests that ambiguities within the major parties will have a bearing on the future pattern of integration comparable to that of the bipolar executive.

Until 1982, this bipolar executive had been supplemented by the parallel legitimacies of the revolution and of the vote - impairing the government’s willingness and ability to stabilize and liberalize the economy. Liberalization had not been accepted easily by any major political force until the mid 1990s, and, both in and out of power, the social democrats are more

anxious to avoid being branded as pro-business than the socialists. Their preference for some form of social pact was evident in efforts to accommodate the objectives of the non-communist trade union - the general workers' union (UGT) - in the disinflation process initiated in 1985. The employers' confederations - especially the confederation of Portuguese industry (CIP) - also agreed to base wage increases on expected inflation in 1986, but the agreement broke down in 1988 when the inflation outturn was almost twice as high as the target.

After the widespread privatization of state-owned enterprises began, the situation improved, in spite of a reform of the civil service pay grid in 1991. Overall, the additional fiscal costs have led to larger fiscal deficits, rather than to improving the efficiency of the existing public administration. This is of course another reflection of a bias towards a large public sector. But it is also an illustration of the role of the minister of finance in a state-controlled developing economy. For decades, the absence of political parties and other democratic institutions made it easier for the government to solve the coordination problem between spending ministries and present and future taxpayers. In the strong single-party executive governments of 1985-95, instead, ministers of finance earned credibility abroad through unpopular structural reforms and were replaced after two years on average. In the run-up to the elections, ministers of finance sold stability at home by allowing increased deficits.

The regime change towards currency convertibility and stability brought about by the ERM increased the independence of the central bank and withdrew the monetary constitution from the minister of finance's responsibility. Nevertheless, its reversal in 1990-91 and difficulties in coordination in 1993-94 are consistent with the oscillating pattern described. The pattern of alternating between international and domestic objectives in macroeconomic policy making did not remain associated with the task of moving the *escudo* into the euro since the decision to veto a cross-border bank merger had a clear domestic objective. In any event, it is the failure to carry out structural reforms, not a specific decision – no matter how misguided – that threatens the benefits to people and to business of being again endowed with a stable and convertible currency. If the awareness of the threat rises, the pattern may re-emerge even though one party has won both the presidency of the republic and the government, along with the major cities¹⁰.

The drop in mutual political responsiveness in summer 1999 reflects the negative credibility effect but it was offset domestically by a continuation of political stability brought about by the reelection of Guterres. This revived financial protectionism confirms that the run-up to the euro was not sufficient to eliminate the interests vested in public administration and some economic groups. Accordingly, the new finance minister, Pina Moura, is seen as both more business friendly and more capable of delivering stability at home than his predecessor Sousa Franco.

3.2. The comparative dynamics of the bipolar executive

The foundations of the Portuguese political system written in the 1976 Constitution included tight political constraints on social dynamics, which were not overturned until 1989. True, the political regime was clearly based on majority rule applied to all citizens. But the state also had to establish a "classless society" (article 1), given "peace and justice among peoples" in the international system (article 7, no. 2). The economic program that attempted to carry out this transformation ignored the existing world economy – in particular the European Community – and froze the public sector at the enlarged level it reached in 1975 (article 85, no. 1).

¹⁰ In emerging markets, especially in CEECs, the special role of the minister of finance and of the central bank governor may lead to the same oscillation.

That an enlarged public sector remained legally frozen until 1989 is indicative of the ambiguity of public response towards European integration. Politically it was important to balance European integration against constitutional socialism throughout the eight years of negotiations with the Community, and even beyond entry. To be sure, conflict between the commitment to European integration and the commitment to socialism was associated with personal rivalries between prime minister and president of the republic. Yet the ambiguity of integration policy in the years after the revolution stemmed from the bipolar system of government as much as from personalities. Juan Linz (1982) has stressed the dilemma of the bipolar executive in Portugal¹¹.

The objective of EU membership was repeatedly emphasized by Soares, prime minister from 1976 to 1978 and again in 1983-85. Conversely, the objective of a socialist economy was defended by the military leaders from the African wars gathered in the revolutionary council chaired by general Ramalho Eanes, the president of the republic from 1976 to 1985. Furthermore, until the first constitutional amendment abolished the revolutionary council in 1982, the loyalty of the president was divided between the electorate who had voted him into office and the army, represented by the revolutionary council. Before 1982 the rivalry between the two poles of the executive was particularly crippling. Despite the efforts of the Carneiro government in 1980, the economic consequences were progressive expansion of the public sector without any attempt at reform and continuous squeezing of the private sector. Mounting public sector deficits were an inevitable corollary. By the time the revolutionary council was abolished and the powers of the president of the republic were reduced, the problems had become too great to be easily resolved. A succession of coalition governments (successively led by Balsemão and by Soares) proved incapable of bringing order to public finances.

An anti-inflationary program, coupled with the first steps towards fiscal adjustment, was adopted late in 1985, with the election of another reformist government of the social democratic party led by Cavaco. Even though the government's candidate for the presidency lost, the rivalry between the two poles of the executive subsided shortly afterwards, when Soares became president in February 1986. The popularity of the reformist strategy was strikingly confirmed by Cavaco's landslide victory in the elections of July 1987.

The government made its intention to revise the constitution and unfreeze the public sector known during the electoral campaign. Victory set the stage for the second constitutional amendment. This took two years to achieve, however, because to reach the two-thirds majority required passing an amendment, some kind of arrangement had to be reached with the socialists, which were then led by Victor Constancio, another central bank economist. Perhaps anticipating the difficulty of such agreement, the Cavaco government decided in November 1987 to sell 49% of the capital of state-owned enterprises to private investors without waiting for the amendment to the constitution. In attempting to divorce ownership from control, the decision made the privatization process more complex but not necessarily faster. The very gradual nature of the privatization process can be viewed as another reflection of the ambiguity of integration policy.

Diagram 2 Dilemma of bipolar executive

The dynamics of the bipolar executive system are illustrated in Diagram 2 by the combination of two variables. The structure of the party system is decreasing on the horizontal axis and the influence of the president of the republic on the parties is decreasing on the vertical axis. The combination shows to what extent the two variables are able to produce a parliamentary majority for the cabinet. The "structure of the party system" can be inferred from the number

¹¹ See also Werner Kaltefleiter (1970) and Maurice Duverger (1978).

of parties, their organization, and the stability of coalitions. In the end, however, it is the stability of voting patterns that determines how structured the party system is.

The Portuguese dynamics are compared to three others, especially the French – as it is the most influential in the Portuguese political culture. The origin in Diagram 2 represents a stable combination of a structured party system and a president of the republic who is also the head of the party in power. This has been the experience of the fifth republic in France at least until 1986, when the move to proportional representation led to a rise in the extreme right party and to several experiences of what the French call “cohabitation” between the two poles of the executive. There were episodes of “cohabitation” between different right-wing parties, especially the government of Raymond Barre between 1976 and 1981. Nevertheless, the term was first used to describe the combination of right wing prime ministers under the socialist president François Mitterand (Jacques Chirac in 1986 and Edmond Balladur in 1993). Since 1996 president Chirac has a socialist prime minister, Lionel Jospin, so that the French system has been moving rightwards on Diagram 2.

The extreme case of instability is the combination of a paralyzed party system without presidential influence, as happened in the final days of the Weimar republic (1930-1932). One intermediate case is the non-structured party system where the president of the republic is the head of the majority party, as happened in the Weimar republic from 1919 to 1922 and has existed in Finland since 1956. Another intermediate case is the structured system where the president of the republic has no influence on the majority party, as happened in Austria from 1950s to the mid-1960s. Yet another is the structured system where the president of the republic has influence on the majority party, as happened in Austria subsequently.

The evolution of the Portuguese system, also plotted in Diagram 2, presumes that, at the time of the 1981 amendment, it was a non-structured party system where the president of the republic has little influence over the majority party. It could have evolved in the direction of the Austrian model of the late 1950s had the structure of the party system been reduced to the two main parties.

As it turned out, Portugal follows the pattern of France but in the opposite direction until 1996, when the coincidence of socialist president Jorge Sampaio and prime minister Guterres makes the Portuguese path approach the French position in the early 1960s and in the early 1980s.

4. The fiscal constitution

4.1. Voracity and the resilience of the public sector

If there is no private sector, there is no separate public sector and no public sector deficit or debt. Without a private sector, there is no one for a public sector to have a deficit with. Monetary policy is simply the provision of finance for investment in the plan. Essentially fiscal and monetary policies are the same thing. As the economies move through the transition, privatization creates a private sector and the distinction acquires macroeconomic significance.

Fiscal policy gradually emerges, as the concepts of public expenditure, tax revenues, government budget, and public debt become operational. With the creation of a central bank, and the withdrawal of the central bank from automatic financing of the budget deficit, monetary policy emerges as the provision of credit to the private sector. During the transition, the CEECs are expected to introduce market-oriented policy-making institutions in which the distinction between fiscal and monetary policy is clear. The use of these policies in maintaining internal and external balance can also be interpreted along the lines proposed in joint work with William Branson and Jurgen von Hagen (1998).

The point though is that all national economies face an external constraint. Foreign debt cannot become so large that international financial markets perceive that it cannot be serviced. Export earnings must be sufficient to finance imports and debt service. Therefore, signs of internal imbalance, either excessive budget deficits or unacceptably high inflation, may be taken as indicators that a currently satisfactory external situation could become unsatisfactory in the future, as the internal imbalance spills over to the external sector. This spillover certainly existed in the Portuguese experience but the pattern of export growth under limited financial development allowed intervention by the government and the central bank to remain high in the 1960s and 1970s – with very different ideological justifications but the same appeal to protectionism. In effect, a strong financial market implies not only less interference on the part of the government but also a clearer notion of what the public sector is.

The major obstacle to a more transparent fiscal policy - revenue seeking - was eroded by the increased factor mobility that the single market in financial services entailed. Nevertheless, the bias towards a large public sector brings a preference for hidden taxation and disguised fiscal policy, which is reminiscent of what CEECs were like before the transition began. In Portugal, there was no public debt hangover for the democratic regime; liberalization cum stabilization packages were agreed upon with the IMF but this external pressure was accompanied by mounting public deficits.

In a series of papers, Tornell and Lane have shown how the power of vested interests can be perverse for society as a whole. In particular, an increase in the rate of return to capital in the taxable sector, which typically coincides with exports (whereas the “informal” sector involves import or import substituting production), leads to a more than proportional increase in discretionary redistribution. This “voracity effect” remains operative in Portugal even when external pressure brought government budget deficits under control. From 1991 to 1995, the effects of increased EU structural funds interacted with the electoral cycle and with the European recession, leading total expenditures to rise faster than GDP until this is offset by the reduction in debt service. The pattern is the same from 1995 to 1999.

Chart 2, updated from César das Neves (1994), shows the ratio of primary government expenditures to GDP from the early 1950s to the late 1990s. The figure excludes interest payments, which rise from nothing in the 1970s until close to ten percent of GDP in the early 1990s and then fall as credibility is earned. The expansionary effect of the post-revolutionary frozen public sector goes on until accession, even though it is partly reversed during negotiations for membership. This was due to liberalization cum stabilization packages agreed upon with the IMF but it was the pressure of external balance rather than an attempt at tackling excessive state intervention, which, in spite of widespread privatization in the 1990s, has remained to this day.

Chart 2 Government primary expenditure as % of GDP 1951-1999

The rate of increase of the GDP deflator fell from 23% in 1983-85 (during the second IMF program) to 15% in 1986-88, while stagnation was followed by a 4% growth rate over the same period. The improvement in inflation was matched by a reduction of the public sector deficit from 11% to 7% of GDP but there were reversals on both counts. From 1991 to 1995, the effects of increased EU structural funds interacted with the electoral cycle and with the European recession, leading total expenditures to rise faster than GDP until this is offset by the reduction in debt service. Between 1977 and 1985, the implied deficit was on average double the reported deficit shown in Chart 3.

Chart 3 Budget deficit

The reported government budget deficit was above the ceiling of 3% of GDP imposed by the EU Treaty until 1997, except for 1989 (when the introduction of comprehensive income taxation led to extraordinary revenue increases). In 1991 (elections) and 1993/94 (recession),

the downward trend of the deficit is reversed. The oscillations go a long way towards explaining how the public did not appreciate the change in regime until 1995.

The downward trend in the government budget deficit was embodied in the convergence program presented after the 1991 elections. This program implied a credible MAFAS seeking to stabilize the accumulation of public debt through increases in revenue and decreases in expenditure such that, excluding interest payments, there is a budget surplus. A variant of this benchmark is of course incorporated in the *Stability and Growth Pact* of 1996.

In 1988 debt stood at over three-quarters of GDP but would rise to 100% when 'guarantees' provided by the general government for loans to public enterprises are taken into account (the debt of the electricity company alone was about 20% of GDP in 1987). To the extent that these loans will never be repaid, the existence of these 'guarantees' justifies the notion of a frozen public sector and voracious vested interests. These operate in the general government and also in state-owned enterprises, including both financial and non-financial enterprises, but they also include private economic and financial groups devoted to import substitution of one kind or another. In other words, to the extent that the adjustment process has largely spared government expenditure, the existence of implicit taxes and hidden deficits is also consistent with this voracity effect. The absence of restrictions on public spending, central to the pattern of macroeconomic adjustment observed in Portugal since the revolution, implies larger increases in revenue and resorting to hidden forms of taxation.

The pressure of the single market deadline was not strong enough to affect the design of the 1988 Tax Act. The introduction of comprehensive income taxation in 1989 did not increase the credibility of a future tax reform in which concealed taxation would be reduced to a level consistent with external financial liberalization largely because of the priority given to selling stability at home ahead of the 1991 general elections. On the contrary, the doubling of Community structural funds secured in 1988 brought additional pressure on public investment expenditure, because of the requirement that recipient countries match these funds to an equal amount. It also increased rent seeking within the private and public sector along the lines of the voracity effect. It is true that, after the elections, the government tried to become a "good student" and, through a MAFAS, was able to commit itself to restoring control over public finances. This commitment did not prevent an increase in primary government expenditure, following the new duplication in EU structural funds decided in late 1992.

Before the MAFAS, the broader measure of public debt shows a ratio to GDP increasing at 4% a year for over ten years, despite high growth and negative real interest rates. Unreported lending operations by the Treasury and debt take-over operations by the government (to the benefit of autonomous funds as well as of state-owned enterprises) make the decomposition of stock accumulation into well-defined flows difficult to interpret on a year-to-year basis¹².

The continued pressure for a credible MAFAS notwithstanding, the previous pattern of slow adjustment on the tax and expenditure side continues. In particular, the improvement in tax administration has been in the government's program for over ten years. Unless public finances are reformed, a resumption of "stop and go" macroeconomic policies will be unavoidable, even within the eurozone. The inability to reform the public sector reflects a propensity for state intervention and vested interests in the distribution of increased structural funds which reflect in turn the imbalance between economic and political integration

¹² Before the revolution the reported surplus was hiding a deficit, except in 1972 when the reported deficit was hiding a surplus. Between 1977 and 1985, there were substantial year-to-year variations of the implied deficit in relation to the reported deficit, especially in 1980 because of a debt write-off operation. On top of the reported deficit, there was a hidden deficit of equal size. In 1986-88, there was a hidden deficit of 6%, while the reported primary budget deficit was about zero. See Bliss (1990).

described in Diagram 1 above for the last fifty years.

Even when the aversion to open markets was most vocal, Portugal always kept an export sector in private hands. This export sector which had boomed in the 1960s thanks to EFTA, had always behave like a kind of enclave, which did not receive much attention from the authorities but also did not appear to contribute much more than the ironic reference to a “pajama republic”. This is why it seems to fit the description of a lower-productivity “informal sector” where taxation is absent. Capital flows to this informal sector when taxes and transfers rise, because interest groups want to increase their share of the common pool and consequently depress the rate of growth of the economy. This happened during the EFTA period, when intra-industry trade remained limited and exports of labor-intensive manufactures (namely textiles and clothing) rose alongside emigration. This was the time when foreign exchange was abundant and industrial policy was targeted at national integration with the larger African territories, Angola and Mozambique. The threat of a balance of payments crisis appeared shortly after the revolution and the independence of the colonies, but it was ignored with the argument that the Portuguese economy was set to become centrally planned and the private export sector would dwindle.

While devaluation and a credit squeeze achieved external balance, monitored by the IMF, the fact is that government expenditure and transfers to state-owned enterprises did not adjust. This is the lesson mentioned earlier, to which the voracity effect was added. The conflicting needs to undertake sizeable public investments for meeting EU standards, especially in physical infrastructure, and to reduce the fiscal deficit were not reconciled through public sector reform coupled with improvements in competitiveness, including lessening labor and capital market rigidities.

Instead, fast growth and a slower disinflation that desirable facilitated the adjustment. However, the 1983/85 structural adjustment spared the public sector, so that rising nominal wages and interest rates exacerbated the appreciation of the real exchange rate, and may have pushed beyond the sustainability level in the early 1990s as controls on capital inflows were also imposed. This resulted in a further misalignment and threatened the sustained output and employment expansion.

In early 1992, the sequencing changed with the introduction of a MAFAS with nominal ceilings on primary expenditure (rather than in the ratio to GDP) and entry into the ERM. In spite of the fear of sudden reversals of capital inflows during the ERM crises, the authorities were able to realign the exchange rate without credibility loss because they followed the peseta. This is a case where the “geographic fundamentals” actually helped avoiding an exchange rate misalignment which could have threatened moving the *escudo* into the euro. The lesson for CEECs is that a rule based exchange rate regime provides a credibility bonus relative to various forms of domestic discretion, even if these forms belong to an independent central bank¹³.

4.2. Balancing financial and civil society development

Behind trade adjustment and labor dislocation, balancing financial and civil society development appears to be the crucial ingredient of a successful transition. The Portuguese case helps bring these elements together. The ability to shift from inter- to intra-industry trade largely determines the capacity to transform and hence the pattern of specialization. Under the specialization based on the abundance of semi-skilled labor, which happened under EFTA, the dislocation of labor and unemployment from agriculture and industry towards services faced greater structural rigidities than if Portuguese firms had become competitive in differentiated products. This dislocation of labor had a sectoral basis – such as from

¹³ This is discussed in my (1999).

agriculture to industry or from one sub-sector of industry to another. The decline in agricultural employment has been compensated by increased employment in manufacturing and even more so in services, while employment in public administration also grew massively. These sectoral shifts have been associated with substantial migration from rural to urban areas. The activity rate in Portugal is slightly higher than in the EU, and so is the proportion of women in the civilian labor force. The proportion of self-employed workers is very high and so are average hours worked each week. Employment has risen at an average annual rate of close to .2% from 1960 to 1990. The rate in 1991 reached 2.8%, became negative in the next few years and rose again to 2.4% in 1998, dropping to 1.8% in 1999. Unemployment has not been a problem since the late 1950s. Nevertheless, 'underemployment' may be widespread because of the highly bureaucratic public (and private) administration and because of the high cost of adjusting manpower. If the organization of the economy changes, there will be a large potential for workers to be released to undertake new activities. These workers, however, are generally poorly trained and lack special qualifications.

Labor dislocation had a regional dimension, but unemployment remained low by EU standards, so this has not led to lower public support for membership. The rate did jump in 1977 and kept rising to reach 8.7% of the labor force in 1985. It declined again until 1991, when it reached 4%, and rose to 6.8% in 1997, dropping to 5.1% in 1999.

The structural adjustment was accelerated by the requirement to fully liberalize capital flows and by the fact that the amendment of the constitution in 1989 made Portugal more attractive to foreign investors. Both an increasingly open capital account and higher capital inflows complicated financial sector supervision, especially in connection with Spanish banks.

With the benefit of hindsight, the lessons of experience Portugal could offer for minimizing the costs of adjustment with respect to its accession negotiations may relate to the long adjustment period implied by the negotiations. While in principle gradual adjustment is desirable, when it is combined with an ambiguous response to external liberalization it may lead to defensive policies and increase rather than decrease the costs of adjustment. In the case of Portugal, this effect was not as severe as one might have expected because unemployment benefits were not large enough to create a strong disincentive to work. There were other domestic policies (such as worker retraining) but they do not seem to have dealt with the social costs of adjustments resulting from accession.

Accession-related demands on public administration notwithstanding, Portugal's public sector remains devoid of administrative capacity and the delivery of public services is poor, breeding corruption, a typical symptom of poor governance. Rather than demands for establishing new EU dedicated institutions, there was modification and adaptation of existing public institutions, such as the central bank and other supervisory agencies (energy, telecom, and financial services).

The budget process continues to feature lax tax administration. On the other side, the parliament's role in expenditure control has been uneven, especially in the absence of a strong executive, before 1985 and since 1995.

The influence which EU integration has exerted on the development of civil society is inseparable from the rising income per capita and from the development of a media landscape. Here two episodes are worth citing. After the revolution, the state owned channel, controlled by the communists, tried to push soviet-style material and fell into severe disrepute, helping to foster the civil resistance against the military regime led by party leaders in the Spring and Summer of 1975. After the privatization of newspapers and television in the early 1990s, licensing two other TV channels besides the state-owned one, in particular, is said to have accelerated the downfall of the social-democratic government in 1994 and 1995.

António Barreto (1996) stresses the importance of the media in providing information, that is “power” to the citizens¹⁴.

The voracity effect focuses on the appropriation of capital but the importance of real wage adjustment in Portugal is consistent with a view that the authorities neglected employment in the informal export sector. The government concentrated instead on taxation and employment in the formal, import substituting sector.

In the wake of the revolution, trade unions and other workers’ organizations, which had been docile under the corporatist regime, engineered steep real wage increases. At the same time, because they had become accustomed to a stable exchange rate, workers were unaware of the erosion in real wages that currency depreciation caused between 1977 and 1985. This allowed the “stop and go” policies of successive governments to result in falling real wages during most of the post-revolutionary period. Despite the 1976 law, which confined lay-offs to the most extreme cases, the labor market maintained a degree of flexibility, as employers hired employees on renewable short-term contracts (usually 6 months)¹⁵.

As shown in the next section, the population did not share this neglect of private employment: workers tolerated brutal falls in real wages to keep their jobs. In particular, they behaved as if they understood that when the relative price of their exports and imports declines, the real wage has to decline as well.

5. Macroeconomic management

5.1. Output and real wages

Since an economy is often smaller in import than in export markets because import markets tend to be more concentrated, international trade patterns must be sufficiently diversified for the supply of exportables to be constrained only by the domestic resource endowment and by the domestic demand for exportables. Not having to face export quantity constraints is, of course, the most desirable consequence for a small country with increased structural interdependence with a large area. Otherwise, exchange-rate devaluation – while able to reduce wages in terms of traded goods – may not be able to improve the current account deficit without a deeper depression in economic activity and a further reduction in the standard of living of the population.

Consider a small open economy where macro-economic equilibrium is defined by a combination of real output and real wage. If, from a situation of balance in the current account, the real wage increases, expenditure on goods and services rises relative to output and the current account moves into deficit. To correct the deficit without decreasing real wages, there must be unemployment and thus a decline in output. External balance implies an inverse relationship between real output and the real wage. For simplicity, internal balance is defined by the absence of unemployment, given full capacity utilization so that there is no response of labor supply and output to the increase in real wages. Internal balance is implied by the equality of an exogenous potential output and effective demand. In any event, there is a unique combination of real output and real wage, which keeps the economy in short-run equilibrium.

If we allow for growth of potential output and world inflation, short-run equilibrium can be interpreted in terms of deviation of the observed rates of change of real output and the real wage from their long-run equilibrium values. If the actual growth rate is higher than the

¹⁴ While most of the cultural indicators go to 1994, the number of television sets stops in 1990 because of the abolition of a TV license. Nevertheless, survey data show that 96% of families have one TV set (1996 p.146).

¹⁵ Yet, according to Mateus (1998), the share of short term labor contracts dropped from a peak of 20% in 1989 to about 12%.

warranted rate, inflation will accelerate (and conversely). If real wages grow at a rate higher than the rate compatible with intertemporal real current account balance, the current account deficit will worsen (and conversely).

Diagram 3 illustrates these relationships in terms of the growth gap and the wage gap. At the origin, the growth rate of real output is equal to the growth rate of potential output so that the growth gap is zero. Similarly, at the origin, the rate of change in real wages, or rate of wage inflation, is equal to the equilibrium wage inflation given by change in the terms of trade and in labor productivity, so that the wage gap is also zero. Along the vertical axis there is internal balance while the inverse relationship between growth and wage inflation that preserves external balance is represented by the downward-sloping locus.

The two schedules divide the space into four “zones of economic unhappiness”: when x is negative (Zones 2 and 3), domestic inflation falls and unemployment rises; below the external balance locus (Zones 3 and 4), the current account improves. The dilemma of macroeconomic policy in the dependent economy is clear from the diagram. Zones 1 and 3 (respectively external deficit and accelerating inflation and surplus and unemployment) are compatible with positive or negative wage gaps. In Zone 2 the wage gap is positive and the growth gap is negative. In Zone 4 the wage gap is negative and the growth gap is positive.

Diagram 3 Zones of economic unhappiness

In Diagram 3 the base year of 1973 is taken as positions of internal and external balance. The combination of deficit and accelerating inflation in 1976-77 follows external deficit and unemployment in 1974-75. Surplus with inflation follows the stabilization of 1978-79. The renewed expansion of 1980-82 turns the surplus into deficit until the stabilization of 1983-85. The expansion of 1986-92, initially characterized by a surplus and disinflation, turned towards inflation and deficit, so that the economy moved back to zone 2. The international recession of the 1990s and the membership of the ERM made disinflation credible and growth could resume without an external balance constraint sometime in 1996, bringing the economy back to zone 1.

5. 2. The 1989-92 regime change

The framework developed in joint work with Paul Krugman (1981), based on the adjustment of real wages to reach internal and external balance, continues to help understand the limits of macroeconomic policy a politicized market economy. The Portuguese economy circled around equilibrium for five years, then came close to attaining it in 1980, began a new vicious cycle in 1981 and took over ten years to be back on track. This required a regime change but the drop in the “feel good factor” delayed its effects on public opinion. That the effect of excessively high expectations can be perverse has been widely noted in the process of transition from plan to market, from dictatorship to pluralistic democracy. It certainly occurred in Portugal as well, especially in the wake of the “good student” phase. Conversely, the effect of the last recession was pretty mild.

Unfortunately for high expectations, the process of catching up needs to be coupled with economic restructuring. The banking sector, through privatization or other means, had to absorb the overhang of inefficiency. As with trade and industry, the pressure for financial readjustment came mostly from outside. No excessive regulation in Portugal is likely to last without severe damage to financial development, because business will go across the border to Spain¹⁶.

¹⁶ Against the slow evolution of Portuguese nationalized banks, financial restructuring in Spain began several years earlier and continues, in the form of mergers among large banks, often encouraged by the monetary authorities. See Bliss (1990).

International capital mobility and free trade in financial services, by greatly increasing the competition among banks, was bound to make Portuguese banks unwilling and unable to finance the deficits of the public sector at rates substantially below comparable borrowers. Given the fiscal constitution, this increased the cost of collecting the implicit intermediation tax from depositors, borrowers and shareholders. The new behavior began in 1985 with the new banks and became stronger as banks began to be privatized in 1989. At the same time, the liberalization of capital movements on a Europe-wide scale was delayed until after capital controls had become ineffective¹⁷.

In view of the opening up of domestic capital markets required by the single market objective, the public finance situation in Portugal threatened the sustainability of external liberalization. This led to suggestions that high inflation, high public debt countries, such as Greece and Italy, might together pursue financial repression in a 'soft currency club' which would crawl relative to the ERM, so as to stabilize relative prices throughout the union. The case for such a halfway house was not convincing in the early 1990s and it is not attractive today either¹⁸.

Credit ceilings are a feature of closed capital markets, and in Portugal they proved quite effective during periods of stabilization. Interest rates were kept low so as to alleviate the burden of public debt, showing again how the political element creeps into financial discipline. The only credible measure to end the direct financing of the Treasury by the banks would have been an agreement among the central bank, the ministry of finance and the spending ministries on a plan of deficit reduction involving both expenditure and revenue, and including tax reform. This is the essence of what was attempted in November 1991 with the Convergence Program, but the domestic coordination did not match the commitment at the EU level.

One implication of this lack of coordination is that Portugal's regime change remained misunderstood by public opinion until after the last general elections in October 1995. Aside from domestically generated disturbances that obscured the significance of the change, the combination of recession and system turbulence must be recognized. The lack of credit familiarity with Portugal would have been bad enough for firms and citizens in tranquil periods. In the turbulence which followed ERM entry it was of course much worse and may have contributed to slow down the learning process, especially in the midst of a severe recession and the domestic political instability which preceded the 1995 elections. This lesson is difficult to apply in the current setup of the euro and the so-called ERM2 grid to which currencies from candidate countries might belong, together with the Danish and Greek currencies. Nevertheless, it reinforces the need for balance in the rising economic interdependence and mutual political responsiveness, which Portugal on occasion lacked as shown in Diagram 1 above. Moreover, the role of domestic and international media in spreading news about financial reputation to citizens should not be underestimated. It has certainly been far more striking in the current reversal than it was in 1990-91 when television was still a state-owned monopoly.

Some oscillations in the integration path have been explained by political and social variables. Macroeconomic indicators like productivity and relative prices of goods and factors tell the

¹⁷ Exchange controls kept interest rates in Portugal artificially low, indicating that as barriers to capital outflows they operated very stringently. The average covered interest differential against the dollar between 1984 and 1988 was 0.6% in Spain and about - 3.0% in Portugal. Controls on inflows were tightened in 1990-91, with the opposite effect on interest rates, documented below in the text.

¹⁸ Comparing the rate of crawl and the change in an effective exchange rate with the same weights suggests that the crawling peg of the *escudo*, introduced in 1977 upon advice from the IMF no longer altered relative prices in 1986-88. The change in cost competitiveness was mostly due to the discrete devaluations of the 1978-79 and 1983-85 periods. See Bliss (1990).

same story. A summary illustration of the cyclical pattern of labor productivity relative to the EU average is provided in Chart 4. Accession is associated with a jump in relative productivity growth, which seems inversely related to disinflation policy as it rises in 1989-90.

Chart 4 Relative productivity cycles

The pattern shown in Chart 4 also suggests a “double dip” recession, in 1991 and 1994, when productivity growth in Portugal was 2% below the EU average. In 1991 this was mostly due to high employment creation, whereas in 1994 it was a consequence of a delayed recovery from the 1993 trough. The recession hit harder in 1993 rather than in 1992 and the productivity boom resumed in 1995. It should be noted that both output and employment data have been subject to substantial revisions, so that the more recent swings may well disappear in future revisions.

The decline in the “feel good” factor during the last recession was greater than warranted by the data underlying Chart 4. The specific reason may be that, against the pessimism brought about by the delay in ratifying the EU Treaty after the negative Danish referendum, Portuguese entrepreneurs believed that the Angola market would pick up after the elections, and this turned out to be an illusion.

Nominal relative factor rewards reflected the ups and down of relative productivities and the succession of exchange rate arrangements. Thus, wage increases and long term interest rates converged and diverged before they converged again to the European average. The pattern of relative nominal wage increases and long-term interest rates (what the government called financial moderation) shown in Chart 5 was erratic until the mid 1990s. Wage and financial immoderation certainly contributed to obscure the significance of the PPERR for firms, trade unions and the general public.

Chart 5 Wage and financial moderation

In any event, the real and nominal effective exchange rates against 23 industrial countries produced by the EC and shown in Chart 6 only stabilized after the widening of the ERM bands in August 1993¹⁹. As mentioned above, the rules of the ERM allowed the escudo to realign following the peseta without loss of financial reputation, or with a smaller loss than would otherwise have been the case.

Chart 6 Nominal and real effective exchange rates

The PPERR avoids the “inconsistent trio” of fixed exchange rate, free capital movements, and independent monetary policy by freeing monetary policy to be targeted on external balance, represented by a suitable reserve position. The MAFAS then sets fiscal policy to maintain internal balance, as represented by a low rate of inflation.

Membership in the eurozone seems to suggest that the experience of Portugal was an unqualified success, relative to Greece. Yet, inflation may not have been fully eradicated in Portugal, where it is currently higher than in Greece. Put in another way, the credibility of Portugal’s MAFAS/PPERR must be fed by additional measures of a microeconomic and structural nature, designed to enhance the competitiveness of production and therefore sustain the catching-up process.

It must be acknowledged, then, that the credibility of the MAFAS cannot be seen as definitive, especially if it is not supported by public sector reform, as has been the case in Portugal. This lingering internal imbalance and the failure to carry out public sector reform makes for an unfavorable business environment, which has led to a recent acceleration of

¹⁹ The weekly pattern of exchange rate volatility against the DMark shows that the PPERR followed alternative imposition and relaxation of capital controls and retreat from, then return to, international borrowing. See the reference in note 13 above and EC (1997).

outward direct investment. The absence of reforms has included the rejection of a regionalization proposal in 1998, which would surely have led to greater bureaucracy. Indeed, if the current business internationalization drive is not accompanied by reform in tax administration, justice and decentralization towards municipalities, let alone social security and public health, it may erode the legitimacy of integration. This is what I will call the “euro holdup”, following the conjecture of Willem Buiter and Anne Sibert (1997).

6. Structural adjustment and foreign investment

6.1. Types of international specialization

Alternative types of international specialization must be analyzed in terms of their contribution to national welfare to make it possible for public policy to attempt to favor the specialization most likely to make integration a success in times of global trade wars. Consider a small, closed, competitive economy, which decides to depend on international trade. Since it is open to a new set of prices, this economy will be able to export goods that are dearer abroad and import goods that were dearer at home, thus consuming more goods and services than it would at the old set of prices. If, on top of that, the home country has access to the same technology as the foreign economy, then it will export goods that make intensive use of the factor of production in which it is relatively more abundant than the foreign economy. As a consequence, the return to this factor increases and the return to the other factor declines, but by less than the increase to the abundant factor. This implies that the owners of the abundant factor could compensate the owners of the scarce factor and that, therefore, if compensation were guaranteed, a democracy would (unanimously) vote for free trade. This is why the orthodox theory of international trade holds that free trade is good for everybody.

In practice, the scarce factor is rarely compensated in this way. As well, due to economies of scale and product differentiation, the structure of national markets is rarely one of perfect competition. These two factors cut in opposite directions so that international specialization in differentiated products does not have those consequences on the income distribution by factor which are associated with traditional specialization in homogeneous products. This is consistent with the observation that workers and firms supported the expansion of trade between the advanced economies of the North Atlantic area after the Second World War. On the contrary, according to the traditional theory, it should have been resisted by workers in relatively capital-abundant countries and resisted by firms (capitalists) in relatively labor-abundant countries. This type of trade also explains the spectacular growth rates of international trade between economies with endowments and relative prices so similar that, according to the traditional view, they could hardly have benefited from more international trade.

Diagram 4 Types of industrial specialization

Based on these facts, Krugman (1981) and others proposed models of intra-industry trade to complement the traditional theory of inter-industry trade²⁰. In Diagram 4, the unit square is divided into two zones, I where inter-industry specialization obtains and II where intra-industry is observed. The horizontal sides of the box represent decreasing economies of scale (c) and the vertical sides represent the decreasing difference in factor endowments (z), which is also the index of intra-industry trade. When resource endowments are identical, z is unity and all trade is of the intra-industry variety. When there is perfect competition and no economies of scale, c is unity. However, even when z is zero there will be intra-industry

²⁰ As mentioned above, not facing quantitative restrictions on one's exports is an essential prerequisite for an export-induced growth boom such as the one Portugal experienced in the 1960s. See Krugman (1984)

trade if economies of scale are sufficiently large. Interpreting z and c as referring to the national economy as a whole rather than to a particular industry, the evolution of Portugal during the EFTA period can be represented as going from inter-industry specialization to close to the point of intra-industry specialization. It would seem that, during the same period, Spain entered Zone II while this is more unlikely in the case of Greece. The Portuguese trajectory implies the substitution of traditional exports of food products - including metallic and nonmetallic manufactured goods, electrical machinery, and transport equipment, while exports of textiles grew rapidly. Even under the maintained assumption that macroeconomic adjustment had no effect on the size of the box, the economy is likely to have moved away from the boundary during the 1970s, whereas the success of European integration led differentiated products to be successfully developed and exported.

6.2. Gains from the single market

Available indicators still show greater current account than capital account openness: exports and imports rise from 2/3 to 3/4 of GDP from 1993 to 1997, whereas non-monetary transactions remain around 10%. Patrick Honohan (1995) presents the stock of foreign assets and liabilities as roughly equal to GDP in 1993 and shows that in that year there was a more than tenfold jump in cross border bank assets in escudos, especially at the short end. This shows that, in spite of the greater access to information and the widespread financial globalization in Europe, it took Portugal almost a decade to spread financial freedom to its citizens.

The common external tariff brings the possibility of trade diversion, which in Portugal was sizeable in the agricultural sector, and integration exacerbated the decline which had began in the 1960s. The contribution of agriculture to growth declined from about one-fourth in the 1940's to 4 percent in the 1960s. The situation deteriorated further in the 1970s. The chaotic "Agrarian Reform" conducted by the Communist Party in the Southern Provinces of Alentejo in the summer of 1975 had a decisive negative impact on output and productivity. At the same time, wage increases in the urban sector swelled the demand for food so that agricultural imports rose by 25 percent in 1976 and 50 percent in 1977. It also prevented an attack on the problem of small low-output farms in the North. With accession, a specific program to support agriculture brought new investment but modernization did not proceed fast enough. By 1992, the government decided to move ahead with full liberalization. This reversed the effects on investment.

In spite of the failure to transform traditional agriculture, the trend towards intra-industry trade is undisputed. The single market review produced by the EC in 1997 for the four cohesion countries summarized by Mateus (1998) shows that Portugal benefited by far the most. The static effects on production and consumption associated with inter-industry trade are embedded in a macroeconomic model, which is also capable of tracking dynamic effects. These are firm relocation due to foreign direct investment; greater openness (which in turn increases the multiplier effect of foreign growth); and stronger economies of scale. These in turn foster intra-industry trade along the lines pioneered by Krugman (1981). The estimate for Portugal is an additional GDP growth of .7% per annum between 1995 and 2010, with .5% for Ireland and Spain and no visible effect in Greece.

The pattern of foreign investment reinforces the trade effect. Hans-Peter Lankes and Anthony Venables (1997) have analyzed the determinants of a country's attractiveness to foreign direct investment projects, with a focus on CEECs. They conclude that, in spite of the heterogeneity of the projects in terms of size, function, technology, location and control mode, the progress in transition matters more than the association to the EU - or lack thereof. This analysis is equally relevant to the Portuguese situation before accession and is worth summarizing.

With respect to any particular project of foreign direct investment, its function may be predominantly market access motive (being close to consumers) or predominantly cost motive (being at a low cost production). Projects in distribution or local supply are more concerned with access than export oriented projects, which in turn tend to be more closely integrated in the activities of the firm, and somewhat more upstream.

Aside from the function, the control mode is also relevant: licensing or joint venture projects differ from establishing a fully owned subsidiary. The choice depends on the need to gain access to local contacts and information about markets as compared to the need to safeguard technology and product quality. Wholly owned projects tend to be both more export oriented and have more of their output transferred within the firm.

Countries with perceived political stability and low perceived risk levels are not only more likely to receive larger flows of foreign direct investment but also less likely to have projects postponed or abandoned. The greater security of supply makes these countries more likely to have projects that are relatively export oriented and that are integrated in the sales orientation of the firm. This is the nature of projects located in Portugal during the “good student” period, especially Auto Europa, a joint venture by Ford and Volkswagen established in 1991 and which is now responsible for sizeable exports of differentiated products.

This shows how such projects bring with them the benefits of technology transfer, quality control and the development of marketing channels. They certainly seem to be more in line with the comparative advantage of the host economy. The example suggests that, in determining the flow of foreign direct investment and the type of this investment to Portugal, policy credibility was more important than the proximity to EU markets. The converse could be gathered from some recent examples of disinvestment, to the extent that they may be exacerbated by the drop in policy credibility observed in 1999 and pictured in Diagram 1 above.

7. Conclusion

The case of Portugal is rightly seen as a success of EU accession, but the accession strategy was mostly defensive, as business circles and civil society doubted they could “make the grade”. Inappropriate domestic policies persisted due to resistance on the part of potential losers from integration. The lack of confidence in the country’s capacity to transform and an exaggerated fear of negative influence from Spain prevailed even during the phase when the authorities attempted to be “good students” of European integration. Yet, several ERM realignments initiated by Spain and partly followed by Portugal actually dampened the *escudo*’s real appreciation ahead of entry into the euro.

The opportunity for sustained structural change afforded by the euro and the associated improvement in fiscal discipline has heretofore been lost, making Portugal a potential victim of the “euro holdup”. Public administration has remained incapable of reforming itself in areas such as justice, home affairs, social welfare, education and others. The absence of structural reforms is especially grave in what pertains to the enlarged public sector and the discretionary regulation of private enterprise. This is why the MAFAS/PPERR was such a decisive signal of the change in economic regime. As it turned out, the 1993 recession and the (general and local) election cycles have hindered the implementation of public sector reform.

The competitive forces unleashed by the euro will not suffice to bring about the public sector reform that has been called for more than three decades. To be sure, joining the euro multiplied the effects on firms and consumers of the single market in financial services established in 1993. Nevertheless, the positive response of Portuguese firms to globalization, based on the current virtuous cycle, cannot be divorced from a greater social anxiety than during the vicious cycles before accession. This threat is of course more serious for catching-

up countries such as Portugal. Moreover, a better balance between the European and lusophone allegiances of the Portuguese population which is currently observed did not erase the rise in inequality and the suspicion of widespread corruption suggesting that the propensity for excessive state intervention and perverse redistribution is still present. Both have become social concerns, echoed in the media. That a society without expectations of poverty alleviation may suddenly fracture is of course familiar from Europe and elsewhere.

The accession experience of Portugal is useful politically, economically and socially. Political integration encompasses the executive system and voting patterns, but also public administration institutions and procedures, including governance and the fight against corruption. Economic transformation towards making firms competitive in the single European market requires sound macroeconomic management coupled with well-functioning capital and labor markets. Political and financial stability deliver growth which, given preferences about inequality, sustain social cohesion during the accession process and beyond.

The social dimension is both the most fundamental long-term objective and a very immediate constraint on public policy, ensuring that the EU will remain a shifting objective for accession countries. But the lessons from Portugal will remain essential nonetheless.

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ANNEX 1: Hidden Taxation and Disguised Fiscal Policy

1.1. Banking regulation and competition

A strong financial market implies not only less interference on the part of the government but also a clearer notion of what the public sector is. Moreover, the major obstacle to a more transparent fiscal policy - revenue seeking - was eroded by the increased factor mobility that the single market in financial services entailed²¹.

In highly competitive and unregulated markets, banks tend to avoid the financing of medium- and long-term investment and to concentrate instead on short-term operations. Where control of corporate behavior through mergers or takeovers is restricted (and banks are more regulated), firms tend to be committed to their group's commercial bank, which in turn adopts a more flexible approach and a longer-term view. In Portugal the creation of industrial groups able to finance their activities was a consequence of the excessive financial regulation of the 1960s. Tight regulation of credit - with ceilings established on an individual bank basis - made it essential for an emerging industrial and financial group to avail itself of a commercial bank. Most of the seven 'family' groups were indeed called by the name of their respective commercial bank. Because of the close links of these groups with the government, the competitive fringe of new conglomerates did not manage to bring about industrial and financial restructuring.

²¹ This annex is adapted from Bliss (1990).

Had this fringe been successful, thriving firms might have been able to shop around for more attractive sources of funding, but the financing of the export enclave of small manufacturing firms did not operate in this competitive way. Most firms outside groups, deprived also of the option of borrowing abroad, had to finance their long-term investment through their own resources or through revolving short-term loans. The oligopoly situation of the seven groups, together with the comfortable external position, explains why non-monetary financial intermediaries failed to develop. Excessive regulation was not limited to commercial banks.

Because of their diversified earnings, large industrial and financial groups, such as those identified with the 'seven families', do not require a financial market for investment. In the 1960s the managers of the commercial banks at the core of these conglomerates were nurtured in a type of financial intermediation where most of the operations were internal to the group. As the groups could do without a financial market, after the nationalizations of 1975 they probably took the same view of the nationalized sector as a whole. The closing down of the stock market, shortly after the revolution, reinforced this perception. At the same time, the abnormally high levels of gold and foreign exchange reserves changed its nature. Urged by politicians to put banks 'at the service of the people', the managers saw those reserves as collateral against which the nationalized enterprises were borrowing. But when there is imperfect monitoring of projects by banks, a rise in collateral makes borrowers more likely to default. To compensate for this decline in the expected return of a loan, the bank selects riskier borrowers and projects, which cause expected bank returns to fall. To avoid a fall in profitability, the bank will prefer to ration credit, even if there are no macroeconomic disturbances.

Credit rationing in equilibrium is exacerbated in a disequilibrium situation characterized by binding credit ceilings on private firms. In an inflationary environment, where every borrower, especially the government, faces negative real interest rates, the disequilibrium effect may be very strong. Financial repression made private firms more dependent on bank credit at a time when retained earnings were low and there was no substitute in the stock or bond markets. The heavy dependence of firms on bank credit made the financial system more fragile because banks did not expect some of the debts would be repaid. This reinforced the lack of incentives for creditors to monitor borrowers. It is thus no surprise that after the stock market was revived in 1987 it attracted mostly firms with insufficient retained earnings and with low collateral.

During the expansion of 1981-82, with high wage inflation and controlled prices, profits and retained earnings fell. When interest rates were raised in 1982, the adverse selection effect towards riskier borrowers (who are less reluctant to pay higher rates) was probably offset by a less binding constraint on credit ceilings. This allowed banks a better mix of borrowers and projects. But, in so far as deposit rates were administratively fixed, higher lending rates increased the intermediation margin and reduced the profitability of nationalized banks. Arrears and bad debts accumulated, peaking at 15% of credit to non-financial enterprises and individuals in 1986. At the time non-performing loans were three times as large as the equity of commercial banks. Bad debts fell to about 11% of credit in early 1989, but the figures would be much higher for the nationalized banks, which are also saddled with the need to provide for their staff's pensions.

Paradoxically, the role of nationalized banks in collecting hidden taxes may have helped stabilize the system. The hidden taxes were collected through their excessively wide intermediation margins and passed on through their forced purchases of public debt. Since nationalized banks were acting as collectors of implicit taxes, depositors could be confident that the state would bail them out.

Ten years after the great nationalizations the government finally authorized new entrants, both domestic and foreign, into the banking sector, even though some of them were direct competitors of the nationalized commercial banks. The combined share of the eight nationalized commercial banks in total commercial bank credit fell from 98% in 1979 to 94% in 1985, on account of the rise in the share of foreign banks from 2% to 6%. The share of the eight fell again to 91% in 1987 because of the rise in the share of private domestic banks from zero to 3%.

The new banks avoided holding public debt instruments other than Treasury bills, which had only been introduced in 1984. They were also reluctant to lend to the troubled state-owned enterprises. This meant that they were less exposed to bad debts and suggested a contrast between 'clean' and 'tainted' banks that might prompt depositors' runs on the allegedly riskier banks. The share of private commercial banks is still small, especially on the liabilities side, but their spectacular growth has had a strong demonstration effect on banking competition, stronger than the mere increase in the number of players.

Instead of attacking the debt overhang of nationalized banks, however, the government decided to impose further regulation on the new banks through a ceiling on deposit rates and a (retroactive!) increase in equity requirements. Because the criterion for establishing credit ceilings was related to a bank's capital, there were significant incentives to overcomply, so that the initial negative reaction to the retroactive capital requirements subsided. The only long-term solution is purification of the 'tainted' banks rather than contagion of the 'clean' ones. On the eve of privatization, however, the government announced a series of mergers within the nationalized banking sector, whereby 'clean' (mostly investment) banks were saddled with 'tainted' commercial banks. This procedure, comparable to the engineered mergers of the nationalization period, met with resistance from managers of the well-run nationalized banks. As a result the government withdrew the proposal and the state bought the bad debts of nationalized banks. To the extent that depositors believed that ultimately the state would bail out the nationalized banks, this was indeed the appropriate measure. The consequent increase in public debt was in part be offset by the proceeds from the privatization of most of the state-owned enterprises that were nationalized in 1975.

1.2. Fiscal adjustment in a frozen public sector

Credit ceilings dating from the first liberalization cum stabilization package agreed upon with the IMF squeezed the allocation of credit to the private sector because of the debt behavior of the enlarged public sector. Since the demand for credit exceeds what can be afforded by a responsible monetary policy, the potential excess liquidity ends up in the banking system. The rational response on the part of the commercial banks would be to turn down deposits that cannot find their way into loans. To pre-empt this response the Central Bank created inter-bank securities markets, where through repurchase agreements, banks invested in securities that were part of the Central Bank's portfolio. The rate of remuneration of the banks' excess liquidity was determined through an auction system, which made it a kind of 'market' interest rate. Since liquidity purchases were increasing rapidly - in part because of capital inflows from abroad - a more active interest rate policy was pursued in the inter-bank market. Yet, in 1988, the net effective interest rate on the public debt held by the Central Bank turned negative.

Restrictive measures were introduced in March 1989 which relied mostly on tighter credit ceilings (including much higher reserve requirements) and avoided the large increases in interest rates that would be required to cool off demand. The real interest rate on domestic public debt rose from -9% in 1980-82 to -3% in 1986-88, but the difference with the rate of growth remained negative and large.

Total debt accumulation distinguishes the voluntary from the forced holding of public debt. The former is restricted to Treasury bills; all other holdings of public debt count as seigniorage, which is an implicit tax. The reason for using this definition rather than the monetary base is precisely the focus on revenue seeking by the state. Seigniorage revenue from the foreign counterpart of the monetary base accrues to the foreign state. The interest and growth factor is correspondingly restricted to the debt voluntarily held.

The revenue from seigniorage, given by the net accumulation of non-privately held debt (the tax rate) times the non-privately held debt to income ratio (the tax base) followed an erratic pattern. In 1981 and in 1984 revenue from the central bank was 7% and 8% respectively, and in 1981 and 1985 revenue from the nationalized banking system, including the central bank, reached 9% and 10% respectively. The tax base and rate differ substantially depending on what is treated as being in the public or the private sector. The different base and rate for the seigniorage tax reflect the distribution between debt privately and publicly held, since in both cases net foreign borrowing remains the same. If nationalized banks are aggregated with the private sector, the tax base remains at about 20% throughout the past decade, but the tax rate falls from 10% in 1980-82 to 1% in 1986-88. Conversely, if only Treasury bills are privately held, the rate still falls, from 12% to 3%, but the base actually rises from 34% to 41%. Here only the domestic counterpart of the monetary base is included in the definition of seigniorage. When the change in the monetary base is used, there is a much smaller decline in tax revenue from seigniorage. The difference is related to the strong external position in 1986-87.

To understand fiscal adjustment correctly necessitates going beyond overt incidence. This approach shows the taxation of financial intermediation to be far different from what is prescribed in the tax code. Until financial liberalization was achieved in 1992, there was an implicit intermediation tax imposed on borrowers and depositors in the banking system. To compute the implicit intermediation tax rate, an average rate on deposits can be calculated from the figures for the stock of total deposits and the interest bill paid by banks. The loan rate for the 91- to 180-day maturity (which was administered until September 1988) is representative rate for loans extended by commercial banks during the sample period. Credit ceilings imply that these loans are a relatively small share of the total assets of banks. If the tax base is private credit, then the hypothetical implicit intermediation tax 'revenue' (with an assumed 3% intermediation margin) peaks at almost 10% of GDP in 1982, falling to close to 4% in 1987.

ANNEX 2: A gradual change in economic regime

2.1. Successive exchange rate regimes

The gradual change in economic regime towards price stability and currency convertibility featured several exchange rate regimes before ERM membership. Not all helped the regime change, and one almost reversed it. After membership, though, the system became unstable and the last realignment took place in 1995. We now describe the exchange regimes for the *escudo* prevailing until EMU became fully credible²².

In September 1989, the *escudo* entered the ECU basket at a rate of 172. With hindsight, this marks the beginning of the change in the economic regime, which eventually would move the *escudo* into the euro. Two kinds of measures define the change. Some, like a constitutional amendment reversing the 1976 freeze on privatization, were public but their relation to financial liberalization was not immediate. Other measures like the MAFAS presented to the

²² This annex is adapted from my (1999) and references therein. The use of my name in the third person should not obscure that the assessment is strictly personal.

Commission services were relevant but not public. In spite of these reforms, neither the government nor social partners saw ERM membership as imminent. The cabinet was reshuffled shortly after the 1989 local elections, further delaying public awareness of the ongoing regime change. A *Foreign Exchange Law* where criminal charges were replaced by fines had been approved in the fall of 1989 and was heralded by Miguel Cadilhe, then finance minister, as a major reform. When it was published in early 1990, however, it allowed Miguel Beleza, Cadilhe's successor, to keep the administration of exchange controls with the central bank, from whose board he came to the ministry. In fact, until after the 1991 general elections, the central bank, led since 1986 by Tavares Moreira, determined macroeconomic policy almost completely.

The crawling peg policy was replaced sometime in the spring of 1990 by a shadowing of the DM, known - but not officially acknowledged - as "hard *escudo*" policy. Since the change was not announced publicly, it couldn't be interpreted as a PPERR which would complement the MAFAS. But a very low level of unemployment coupled with a strong upward pressure on public sector wages led to strong inflationary pressures and to the appreciation of the real exchange rate. Moreover, the fear that financial freedom would threaten monetary control and the soundness of the banking system was ingrained at the central bank that administered the exchange controls. Decree law 13/90 of January 8 allowed the central bank to reinstate several controls, which remained under Decree law 176/91 of 14 May, in spite of the principle of freedom stated in article 3. The *Foreign Exchange Law* gave the central bank competence to issue *avisos* (signed by the minister of finance) where capital controls could be introduced or relaxed. On 21 May, the first *aviso* was used to introduce an interest free deposit of 40% of loans contracted abroad (except when the operation related to financing of current transactions) and a prohibition of forward purchases of escudos between resident and non resident banks (forward sales were still not allowed). The controls were reinforced before the general election (*aviso* 7 of 5 July 1991) with explicit reference to the threat to monetary and exchange rate policy that was posed by excessive capital inflows. The tightening of controls was supposed to help prevent inflation from accelerating and to increase the cost of servicing the public debt. Central bank's foreign reserves more than doubled from 1989 to 1991, with disastrous consequences for the bank's operating results. This opaque arrangement managed by the central bank also allowed banks to delay adjusting to a single market in financial services. In short, the bank was accumulating huge dollar deposits earning 5 %, while paying 20 % on the *escudo* debt being issued to mop up the resultant "excess" liquidity and shadowing the DMark, so as to fight inflation. The first stage of EMU was signaled by a speculative attack in favor of the *escudo* and the punt. The volatility of Nordic currencies in late 1991 also suggested that controls on capital movements could help stabilize the currency. These episodes notwithstanding, the first two years of stage one were rather tranquil.

2.2. Earning credibility under ERM turbulence

In July 1990, Beleza had proposed a *National Adjustment Framework for the Transition to Economic and Monetary Union*, known as QUANTUM. Yet, it was not until after the 1991 elections that Braga de Macedo, his successor, presented a convergence program combining MAFAS and PPERR with capital account liberalization, which he discussed in parliament, calling it Q2 to stress the continuity of the gradual regime change. In spite of Q2, the decision to request entry of the *escudo* in the ERM was a genuine surprise. On 4 April, 1992 - the weekend following the approval in parliament of the 1992 budget - the Community responded to the government's application to join the ERM at a rate of 180 *escudos* agreed upon at a special cabinet meeting on Friday afternoon. Even though there was a precedent with sterling, the prior declaration of a parity generated great resistance among several members of the

monetary committee (whose members were acting as personal representatives of the then twelve minister/governor pairs who meet with the Commission in the so-called informal ECOFIN). Under the alleged fear that, on the eve of the British general election, the announced parity of 180 might induce a speculative attack against sterling, a parity closer to the market rate was sought. Finally, the notional central rate of 178,735 - that is the one prevailing since the entry of sterling in October 1990 - gathered consensus. With the benefit of hindsight, the lengthy discussion showed the precarious position of the ERM grid, which was going to imply the departure of the lira and of sterling a few months later. It also suggests that the *escudo* would have been unable to join the ERM in time to meet the EMU criterion of two years' membership. It would have trailed with the Greek drachma outside the parity grid, rather than following the *peseta* inside.

After the cabinet meeting Macedo had briefed the social partners and the following week ERM entry was debated in parliament. Nevertheless the rule-based exchange rate regime which culminated the gradual change in economic regime was neglected at home, perhaps because of the fear of "geographic fundamentals" already mentioned in Section 1. In any event, the central rate the *escudo* kept after the realignment of the *peseta* in March 1995, around 196, would have been difficult to reach without the benefit of the ERM code of conduct.

Evidence to this effect comes from some episodes of domestic controversy, which coexisted with the ERM crises. The episodes also provide early tests for the credibility of Portugal's policy. The restoration of full convertibility by the central bank on 16 December 1992 turned out to be extremely difficult to bring about, as the board reluctantly agreed to have controls renewed for shorter and shorter periods. The elimination was not announced until 13 August 1992, under the threat that legislative action would be taken to withdraw the central banks' power to issue *aviso*s. The effect in is a jump in volatility.

Moreira's board enjoyed the virtual rule on policy-making in 1990-91, including the derogation to the 4th Brussels directive negotiated by Greece and Portugal until 1995. This made it even more difficult for Beleza to accept that the derogation to the 4th Brussels directive should expire in 1993 or 1994 (which is when Greece finished its liberalization). The restoration of full currency convertibility was seen as too risky, especially because it would lower the central bank's control on monetary policy. To lessen these fears, Macedo had introduced several procedures which could have helped establish a two-way dialog between the treasury and the bank. On March 3, 1993, he publicly urged the central bank to adjust to the time of full currency convertibility and to pay attention to the accumulating evidence that the recession was hitting the domestic economy. Two implications of convertibility which had been raised in the sessions with the bank's board were not made explicit in his plea. First, allowing for greater banking competition. Second, lowering money market rates even if it meant letting the *escudo* slide towards the middle of the 6% ERM band rather than being glued to the top. Better banking supervision would lead to a decline in the cost of credit without the need to change the stance of monetary policy. Flexibility within the top of the band would reflect the benefit of the ERM code of conduct relative to opaque DMark shadowing. Some days later, *Reuters* aired rumors that Beleza was to resign in the footsteps of a vice-governor who had been an outspoken advocate of the hard *escudo* policy. While the rumors did not materialize, the adjustment to convertibility was depicted as a crisis rather than as a natural adaptation to greater financial reputation. Thus, the socialist opposition, who was openly questioning the stability-oriented policy contained in Q2 and calling instead for a slower disinflation and an autonomous depreciation of the currency, pretended to see the independence of the central bank threatened by an "authoritarian" government. To the social-democratic business elite, still under the shock of ERM entry, the pressure on the monetary

authority suggested a reversal in the orientation of macroeconomic policy. Domestic controversy contributed to slow down the learning process for firms and citizens about the benefits to be derived from financial reputation but there were no negative international effects and ERM partners believed the code of conduct would be upheld. This can be confirmed by weekly measures of exchange rate volatility.

In the turbulence which followed ERM entry, the lack of credit familiarity with Portugal also had to be overcome. Yet, the central bank, along with favoring capital controls, discouraged international borrowing, which it still associated to situations of looming payments crises rather than to the promotion of the nation's credit abroad. Exceptionally high foreign exchange reserves were another inheritance from the past, and therefore were not used to boost the Treasury's credit rating: Portugal's external debt issues had been assigned a rating of A1 by Moody's Investors Services in late 1986 and A by Standard and Poor's two years later. The divergence between the two agencies remained until late 1991, when Standard and Poor's upgraded to A+ . As soon as the currency was fully convertible, therefore, a strategy of making the treasury known in international markets was designed, involved a planned return to international borrowing, successively in yen, marks and dollars. Standard and Poor's decided the upgrading of Portugal's foreign debt to AA- in May 1993, even though the previous upgrade had been decided less than 18 months earlier. International investors were ready to believe then that economic policy in Portugal would retain a medium term orientation also because this was the first such move since Ireland had been upgraded in 1989. Nevertheless, the strategy was ignored domestically. Shortly after the global dollar issue of September 1993, the deterioration in the deficit, whilst keeping non-interest expenditure at the nominal amount included in Q2, increased the deficit and had a much greater impact domestically than the credibility earned abroad.

The ERM crises were felt by the *lira* and sterling who left the grid on 17 September, 1992 when the *peseta* also realigned but the *escudo* did not. The opinion at the central bank was to deny the "geographic fundamentals" and to stick to DM shadowing, while recognizing that exchange rate policy was a competence of the government. Exporters, on the other hand, were impressed by the bilateral rate with the *peseta* and had been pressing for a devaluation of the *escudo* relative to the *peseta*. As it turned out, the realignment of 23 November was matched and those on 14 May, 1993 and 6 March, 1995 were followed in part, without ever facing the loss in financial reputation associated with initiating a realignment. Quarterly data on capital flows confirm that external credibility was achieved in late 1992 and remained unperturbed by subsequent *peseta* realignments. As there was no memory of speculative attacks against the *escudo*, the domestic turbulence of March 1993 may just reflect the tension between treasury and central bank, or echo fears about the liberalization of capital movements on the part of the banking community. On the other side, the more flexible policy of following the realignments of *peseta* would probably not have been possible to enforce as smoothly without the required change in the bank's operating procedures.

The very low volatility state which otherwise only occurred when the euro became fully credible in late 1997, is also identified just ahead of the first realignment of the *escudo*, from 7 October to 4 November, 1992. The switch to high volatility takes place in the week of 11 November, while the conditional standard deviation drops from .65% to .06% per week. This is an episode of what might be called "false stability", where a strong market intervention by the central bank was able to maintain the rate glued to the top of band before adjusting the central rate. This interpretation of response of the central bank to speculative attacks should be further tested using appropriate intervention data. Nevertheless, it is consistent with the presumption that the decision to enter the ERM could not have been taken much later than

April 1992 and that, given the absence of the prerequisite MAFAS and PPERR, an earlier entry date would not have been credible either.

2.3. Selling stability at home in the run-up to the euro

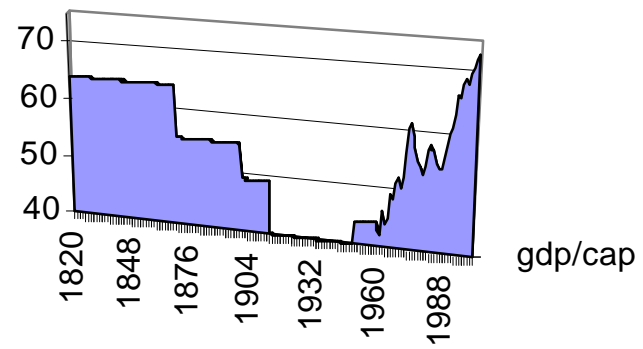
The MAFAS retained in the *Revised Convergence Program* (PCR) approved with the 1994 budget kept the nominal ceiling on non-interest expenditures from Q2 but adjusted the deficit for the revenue shortfall. This was well accepted by international investors who heavily oversubscribed a global bond issue of one billion dollars in September and by the monetary committee who approved the PCR in November. A cabinet reshuffle was announced shortly before the December local elections, involving finance and three spending ministries. Eduardo Catroga, Macedo's successor, kept economic policy consistent with the PCR. In early 1994, a global bond issue in ECU was received with the same success as the previous one. Yet Catroga's call for lower interest rates, while directed at a domestic business audience, had foreign repercussions, especially when they were thought to have the approval of the prime minister. In this context, an Austrian news agency reported rumours of a military coup in Portugal. While entirely groundless, the story was picked up by *Bloomberg* and led to a renewed attack on the *escudo*. Differences on banking supervision between Catroga and Beleza, who had succeeded Moreira in May 1992, led to the replacement of most of the board and the appointment of Antonio de Sousa as governor in June 1994. This drastic move was well accepted, for it was clear that the tension did not originate in monetary policy. Just like the ERM code of conduct moved the *escudo* into the euro, the *Treaty on European Union* and the *Banking Law* (Decree Law ° 298/92 of 31 December) which introduced the single market in financial services and called for greater supervision and competition, forced the central bank to adjust. Further changes have thus been introduced to the statutes of the central bank to make it more independent from the government, to introduce some accountability in parliament and to improve the regulation and supervision procedures.

Another reflection of the continuity of the MAFAS is that the PCR proposed in 1993 extended the expenditure ceilings into 1997. The PCR remained the basis for the excessive deficit procedures until a *Convergence, Stability and Growth Program* from 1998 to 2000 was approved by the ECOFIN in May 1997 where it was presented by Sousa Franco, minister of finance from October 1995 to October 1999. Franco then presented a *Stability and Growth Program* for 1999-2001 shortly after the *escudo* joined the euro at a rate of 200,482. The MAFAS continued listing structural reforms, especially in the public administration but unfortunately dropped nominal ceiling on non-interest expenditures.

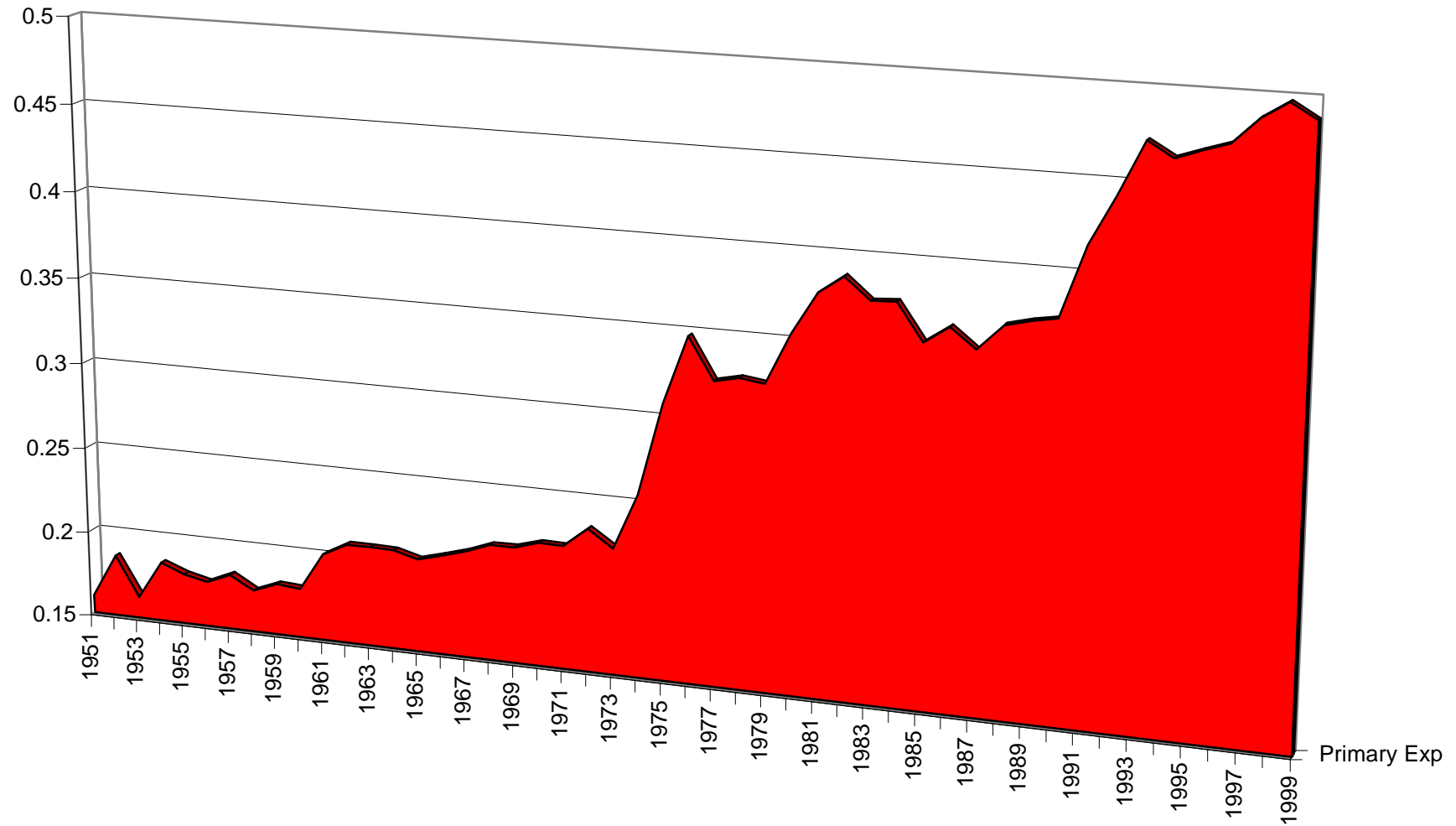
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Long term convergence with EU



Primary Exp



Budget deficit/y 1970-2000

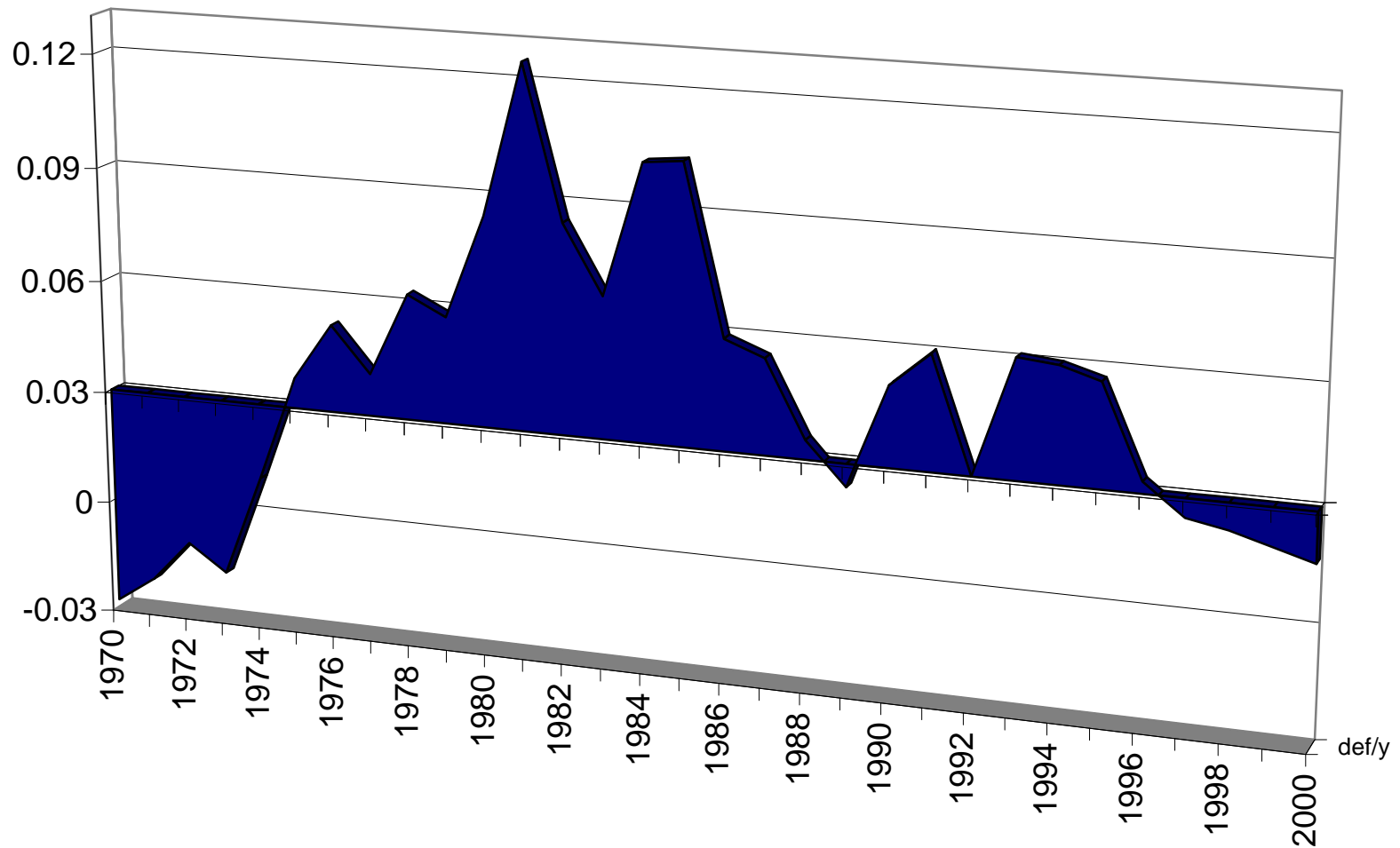


Chart 4 Relative productivity cycles

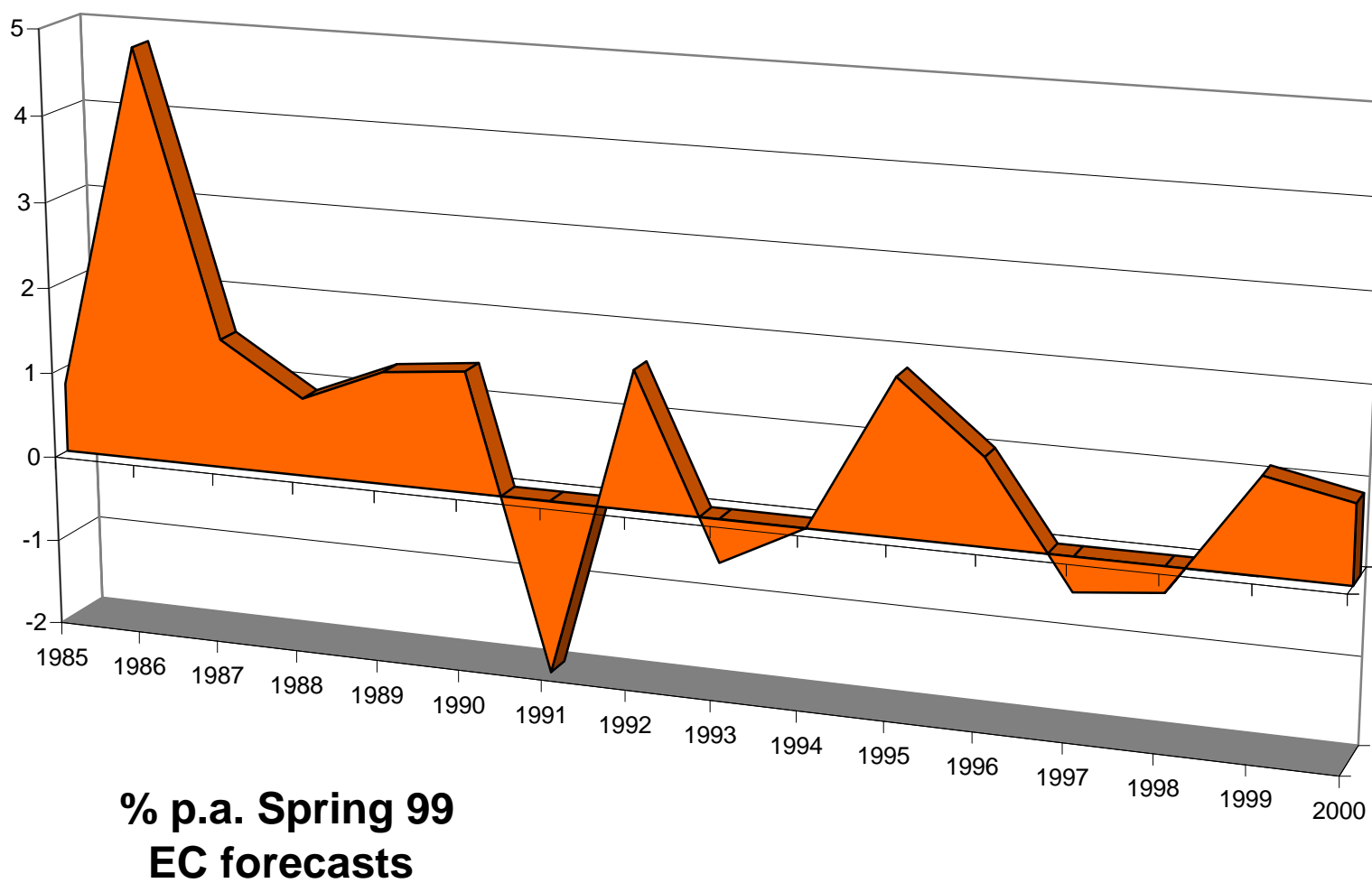


Chart 5 Wage and financial moderation

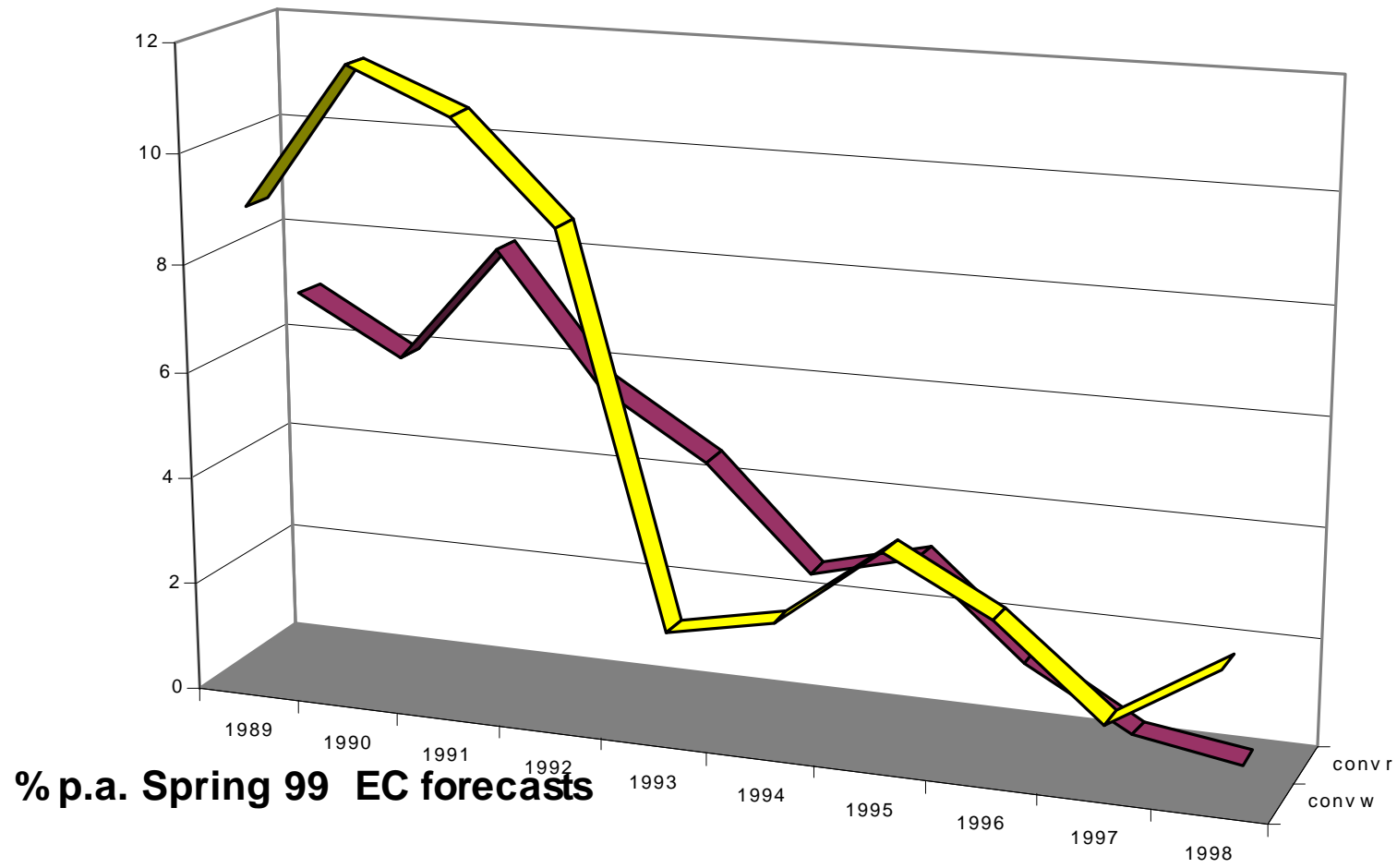


Chart 6 Nominal and real exchange rates

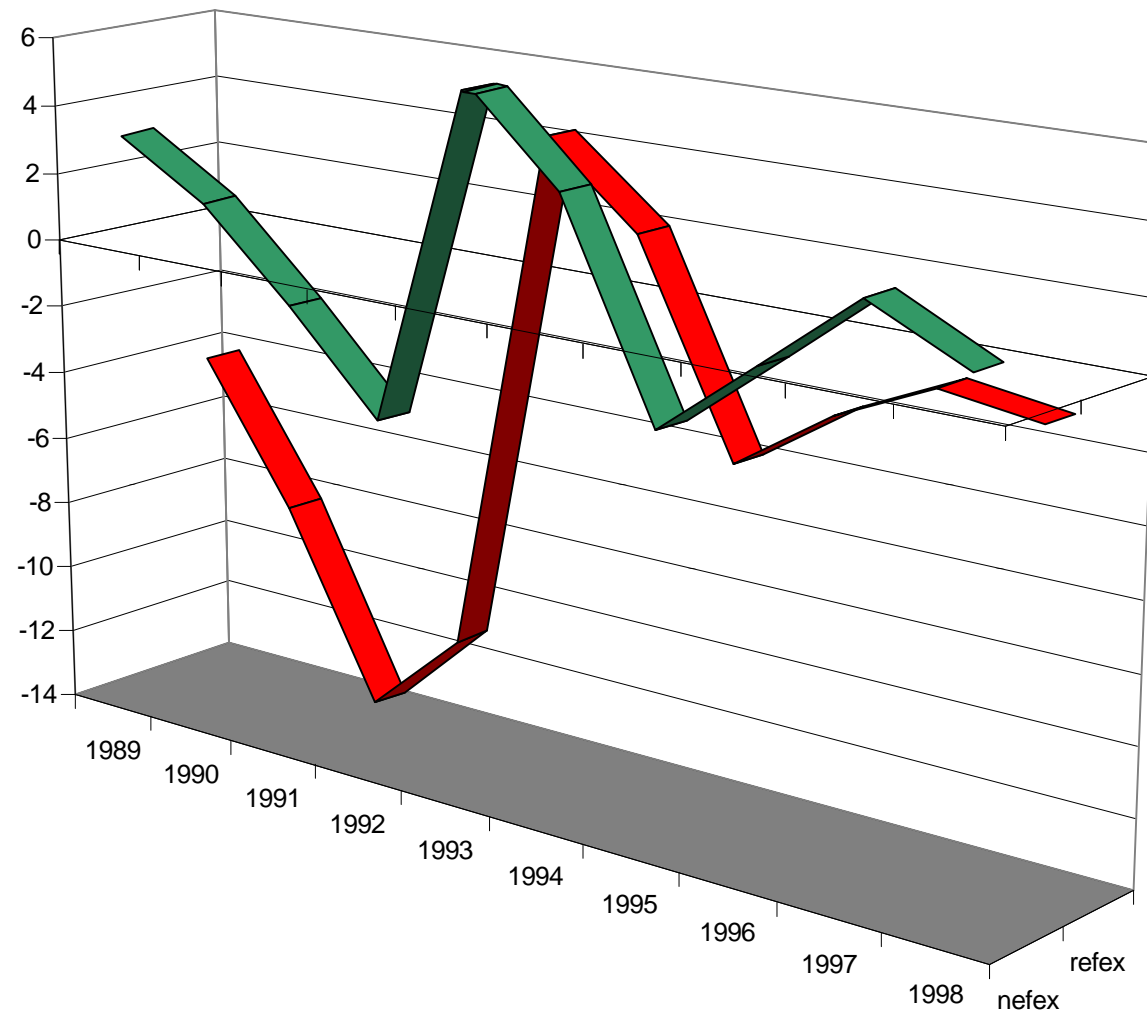
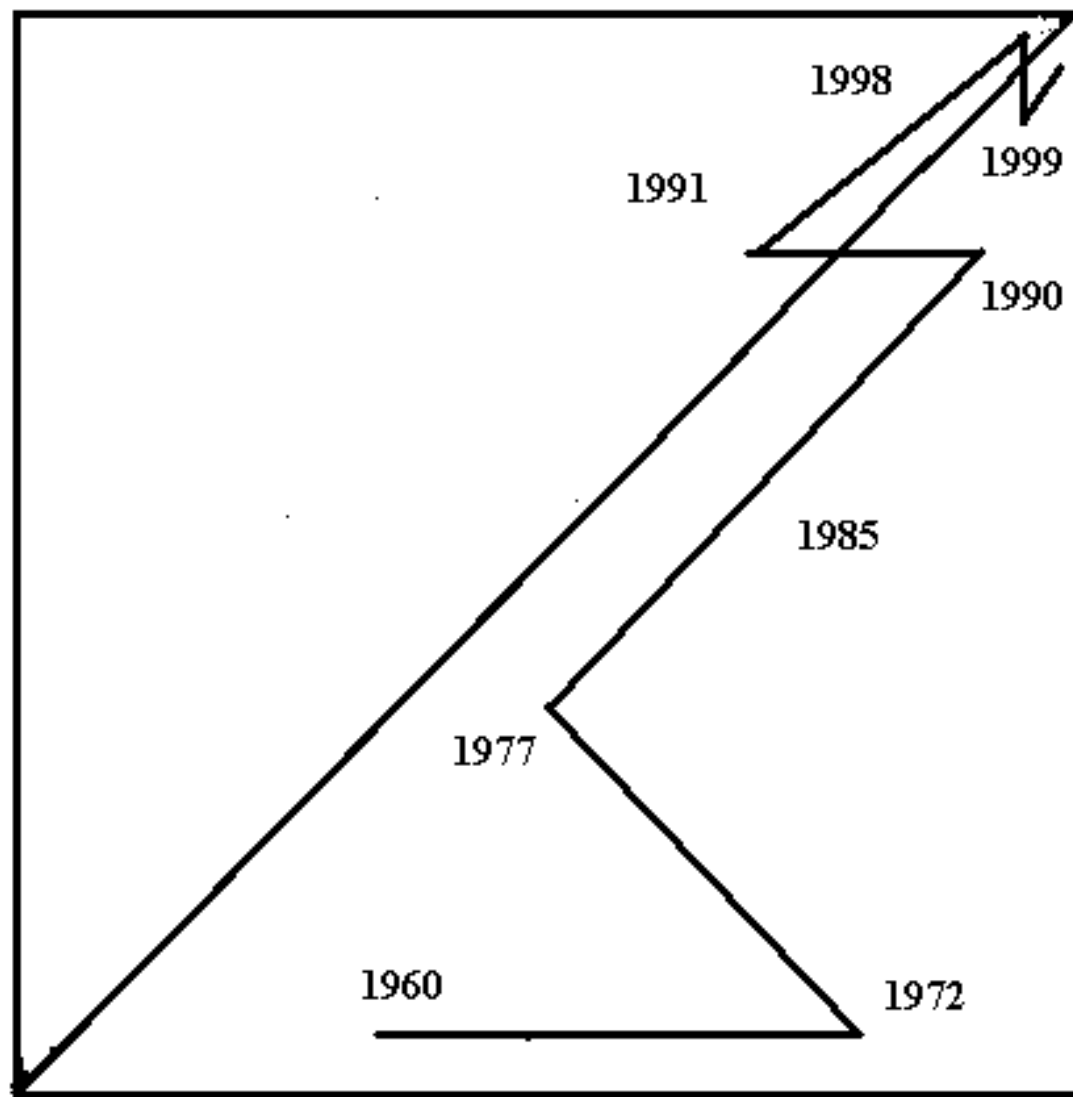


Diagram 1 Pattern of Economic and Political Integration

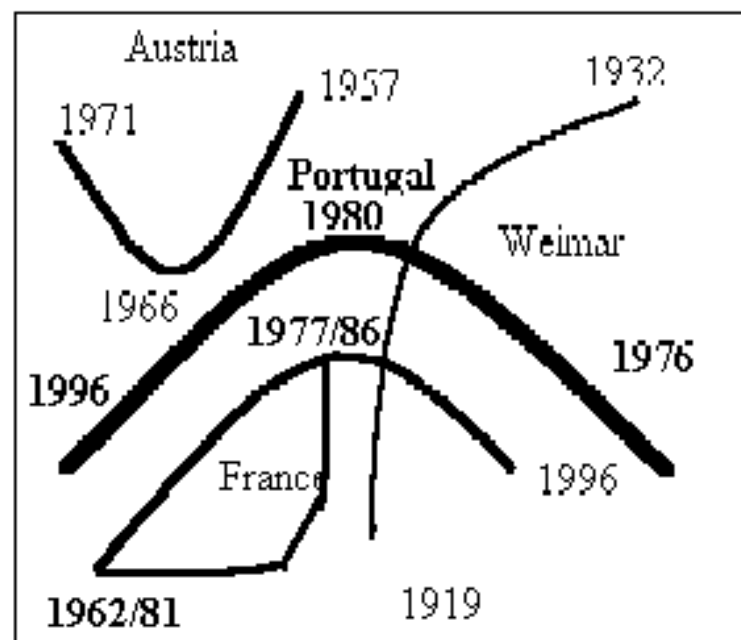


horizontal axis: economic interdependence

vertical axis: mutual political responsiveness

diagonal: balanced path of economic and political integration

Diagram 2
Comparative dynamics
of the bipolar executive

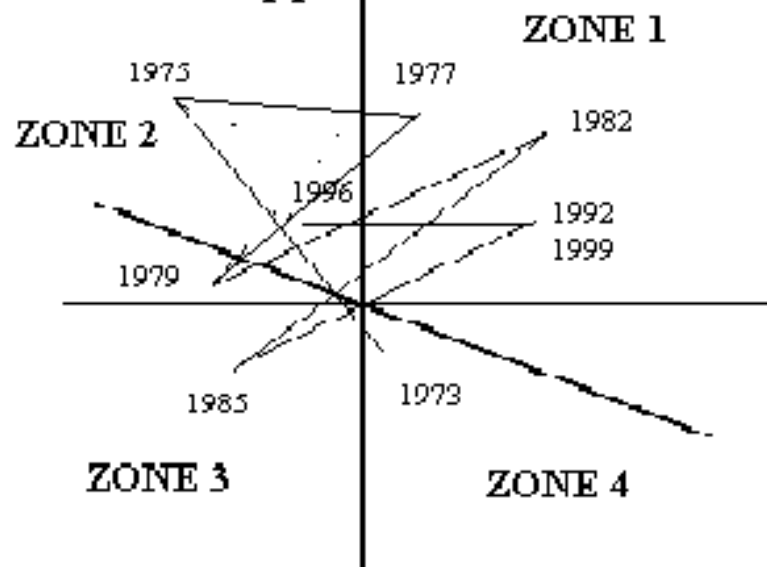


horizontal axis: decreasing structure of party system

vertical axis: decreasing influence of PR on majority party

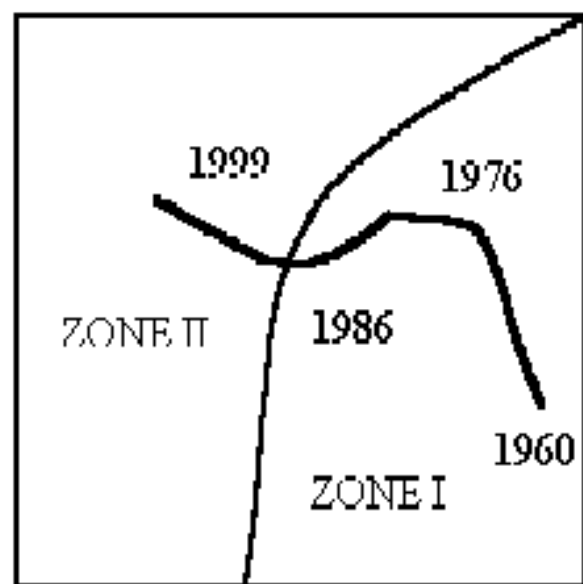
Diagram 3

Zones of economic unhappiness



horizontal axis: growth gap; vertical axis: wage gap
zones 1 and 2: external deficit; 2 and 3: unemployment

Diagram 4
Types of international
specialization



horizontal axis: decreasing economies of scale from $c=0$ to $c=1$

vertical axis: decreasing difference in factor endowments from $z=0$ to $z=1$

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